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REVIEW OF TAX TREATMENT OF MORTGAGE-RELATED SECURITIES AND ENVIRONMENTAL ZONE LEGISLATION

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

S. 1839, S. 1959, and S. 1978

JANUARY 31, 1986

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REVIEW OF TAX TREATMENT OF MORTGAGE-RELATED SECURITIES AND ENVIRONMENTAL ZONE LEGISLATION

FRIDAY, JANUARY 31, 1986

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD-215, Dirksen Senate Office Building, Hon. John H. Chafee (chairman) presiding.

Present: Senators Chafee, Wallop, and Long.

[The press release announcing the hearing and the prepared statements of Senators Chafee and Wallop follow:]

[Press Release, January 8, 1986]

FINANCE SUBCOMMITTEE TO REVIEW TAX TREATMENT OF MORTGAGE RELATED SECURITIES AND ENVIRONMENTAL ZONE LEGISLATION

The Senate Committee on Finance's Subcommittee on Taxation and Debt Management has scheduled a January 31 hearing on three bills introduced during the 1985 session of the 99th Congress, Chairman Bob Packwood (R-Oregon) announced today.

Senator Packwood said the Taxation Subcommittee would review S. 1959, S. 1978 and S. 1839 at the hearing set for 9:30 a.m., Friday, January 31, 1986, in Room SD-215 of the Dirksen Senate Office Building in Washington.

Senator Packwood said Senator John H. Chafee (R-Rhode Island), Chairman of the Taxation Subcommittee, would preside at the hearing.

The bills to be examined:

S. 1959, a measure to clarify the tax treatment of certain mortgage related securities, to authorize the ownership of certain mortgage loans in multiple class arrangements and for other purposes, as introduced by Senator Chafee December 17, 1985.

S. 1978, a bill to clarify the taxation of certain asset backed securities in multiple class arrangements, as introduced by Senator Alan Cranston (D-California) December 18, 1985.

And, S. 1839, a bill to amend the Internal Revenue Code of 1954 to provide that certain deductions and credits not be allowed for expenditures within an environmental zone, and for other purposes, as introduced by Senator Chafee November 7, 1985.

STATEMENT BY SENATOR JOHN H. CHAFEE BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

Good morning. We are today having a hearing on two very important subjects. First, we are going to have testimony on the taxation of mortgage-backed securities. Second, we are going to explore the possibility of eliminating various tax breaks for development of certain environmentally protected areas of the country.

We have quite a number of witnesses, including my colleague Senator D'Amato will testify first this morning, and so I will not make a lengthy opening statement. I am delighted to see such interest in the legislation and I look forward to hearing all the testimony. Since time is of the essence, I will hold all the witnesses except Senator D'Amato and the Treasury Department to the 5 minute rule.

My main purpose in having the hearing this morning is to get the legislative process moving on these issues before tax reform completely takes over the agenda of the Finance Committee. If we can come to an agreement on any of this legislation, there is still a possibility that it could be added to the tax reform bill.

One of the important aspects of moving any legislation in this time of Federal budget deficits is that it not cause any loss of revenue to the Federal Treasury. Thus the comments of the Treasury as to the revenue effects of these proposals are very important. If the Treasury can not give us revenue estimates this morning, I hope they will do so as soon as possible, since that information will play a crucial role in determining the future of these proposals.

We have before us two bills dealing with the taxation of mortgage-backed securities, my bill S. 1959 and a bill introduced by Senator Cranston, S. 1978. Senator Cranston's bill covers not only mortgage-backed securities, but securities backed by other assets as well.

My bill is designed to clarify the tax treatment of mortgage-backed securities, which should facilitate investments in mortgages and thereby reduce mortgage interest costs for home buyers. I have limited my bill to mortgages primarily because there is more data and a better understanding of how mortgages and mortgage-backed securities behave than there is of other asset-based securities.

I am concerned that we clarify two important tax issues with respect to these securities. First, should an entity issuing these securities be subject to a separate level of taxation?

Second, what are the tax consequences to investors in these securities? If we can agree on the tax rules governing mortgage-backed securities, then perhaps we could and should extend this treatment to other asset backed securities. However, at this point I want to concentrate on making certain that the tax rules are correct.

Finally, I notice in the written testimony submitted thus far there is some concern that the Administration may seek to exclude government sponsored agencies such as FNMA, FHLMC and GNMA, from issuing these securities. I do not want to get into a debate on that matter this morning because it is clearly not a tax issue. However, I will say that if the Administration insists upon its position, I fear this legislation will not move forward, and I think that would be a loss for all concerned.

With regard to my bill proposing that tax incentives be eliminated for certain environmentally protected zones, I am very anxious to hear the testimony on this bill. I serve on both the Senate Finance Committee and the Environment and Public Works Committee, and this bill is an attempt to provide consistency in the policies developed in these two committees. We should not be enacting tax incentives in the Finance Committee which would encourage development of lands we are trying to protect in the Environment and Public Works Committee.

Businesses who seek to develop these environmentally protected zones could still do so, but they would get no help from the Federal government in the way of reduced costs through tax breaks. As we all know tax incentives cause a loss of revenue to the Federal Treasury, and as I mentioned earlier, revenue considerations are a major concern in this time of enormous Federal deficits.

In the current debate over tax reform, this Committee will be making some very difficult choices about whether or to what extent we can continue to provide various tax incentives to our manufacturing industry to keep it internationally competitive and thus produce needed jobs here in America. Especially in this context, we should not be wasting needed revenue by providing tax incentives for unwanted development of environmentally protected areas.

In order to allow sufficient time for questions, I would like to go now to our first witness, Senator D'Amato.

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DESCRIPTION OF BILLS RELATING TO THE TAX TREATMENT OF MORTGAGE RELATED AND OTHER ASSET BACKED SECURITIES (S. 1959 AND S. 1978) AND ENVIRONMENTAL ZONES (S. 1839)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

ON JANUARY 31, 1986

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Senate Committee on Finance has scheduled a public hearing on January 31, 1986, on S. 1959 (introduced by Senator Chafee), S. 1978 (introduced by Senators Cranston, D'Amato, Dixon, and Dodd), and S. 1839 (introduced by Senator Chafee). S. 1959 and S. 1978 relate to the tax treatment of mortgage related and other asset backed securities. S. 1839 relates to the tax treatment of deductions and credits for expenditures in environmental zones.

The first part of the pamphlet [1] is a summary. This is followed in the second part with a description of S. 1959, S. 1978, and S. 1839, including present law, explanations of the bills and effective dates.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of Bills Relating to the Tax Treatment of Mortgage Related Securities (S. 1959 and S. 1978) and Environmental Zones (S. 1859)* (JCS-3-86), January 30, 1986.

I. SUMMARY

A. Tax Treatment of Mortgage Related and Other Asset Backed Securities

S. 1959 (Senator Chafee) and S. 1978 (Senators Cranston, D'Amato, Dixon and Dodd)

Present Law

Under present law, income producing assets, such as home mortgages or other debt obligations, may be owned directly by individuals, or may be owned indirectly by means of ownership in a corporation or beneficial interest in a trust that holds such assets. If such obligations are held by a corporation or as an association taxable as a corporation, income tax may be imposed at both the corporate and individual levels on the income generated by such assets.

Under present law, the grantor of a "grantor trust" is treated as the owner of the assets held by the trust. Under Treasury regulations, a trust that has more that one class of interests (e.g., if certain beneficiaries receive distributions of principal before other beneficiaries) is treated as an association taxable as a corporation, and not as a grantor trust.

The application of the present law rules relating to the treatment of original issue discount and market discount with respect to debt obligations that are prepaid is somewhat uncertain.

S. 1959

S. 1959 (introduced by Senator Chafee) would provide rules under which an entity that holds debt obligations, generally limited to mortgages on real property, could issue interests that entitle holders to receive specified cash flows generated by the mortgages, without the imposition of a corporate tax on the entity. Under the bill, such interests would be known as "collateralized mortgage securities" or "CMSs." CMSs could be issued by a corporation, trust, or partnership, and could be in the form of an ownership interest or a debt obligation. CMSs could be issued with different classes of maturities. Holders of the interests generally would be treated as owners of the underlying mortgages.

The bill also would prescribe rules for the taxation of holders of CMSs, including clarification of the application of the original issue discount and market discount rules to obligations whose maturity may be accelerated because of prepayments on the underlying obligations. The bill also would expand the reporting requirements of present law.

The bill generally woud apply to CMSs and debt obligations issued after the date of enactment.

S. 1978

S. 1978 (introduced by Senators Cranston, D'Amato, Dixon, and Dodd) would amend the grantor trust provisions of present law to permit a trust that has multiple classes of interests to be treated as a grantor trust in certain circumstances. The bill would apply to a trust that holds only "financial instruments" that are identified upon issuance of the interests in the trust and that may not be substituted for except in limited circumstances. A "financial instrument" would include most debt obligations, accounts receivable, and lease receivables. Holders of interests in such a grantor trust generally would be treated as holders of interests in the trust property.

The bill would apply to interests issued after April 27, 1984.

B. Tax Treatment of Deductions and Credits for Expenditures in Environmental Zones

S. 1839 (Senator Chafee)

S. 1839 (introduced by Senator Chafee) would modify tax incentives for certain types of investments in environmentally sensitive areas (environmental zones). In general, these modifications are intended to eliminate tax incentives for development in these areas. These areas would be designated by reference to specified Federal statutes.

II. DESCRIPTION OF THE BILLS

A. Tax Treatment of Mortgage Related and Other Asset Backed Securities

S. 1959 (Senator Chafee) and S. 1978 (Senators Cranston, D'Amato, Dixon, and Dodd)

Present Law

Taxation of Alternative Methods of Owning Income Producing Assets

Overview

Under present law, income producing assets (such as mortgages on real property or other debt obligations) can be owned directly, or they can be owned indirectly by means of an equity interest in an intermediary entity. Income generated by property that is owned directly generally is taxed to the owner of the property. Thus, in the case of property owned directly by an individual, income from such property is subject to only one level of taxation. Income from property owned indirectly may be subject to more than one level of taxation, i.e., tax may be imposed both at the level of the intermediary holder and the indirect owner.

Whether more than one level of tax is imposed where income producing property is held indirectly generally depends on whether the intermediary entity is treated for tax purposes (1) as a separate taxable entity (such as a corporation or an association taxable as a corporation), (2) as a complete conduit entity (such as a partnership or S corporation), or (3) as a partial conduit entity (such as a trust or real estate investment trust) for which income is not taxed to the entity to the extent it is currently distributed to the entity's owners.

Direct ownership of income producing assets

Individual ownership

The most basic form of direct ownership of income producing assets is the holding of such assets by an individual. Where an individual owns income producing assets directly, the individual generally includes all income generated by the property, and deducts all items of expense related to the property. When the individual disposes of the property in a taxable transaction, the individual recognizes gain or loss, which may be capital gain or loss.

Grantor trusts

A grantor trust is an arrangement under which legal title to property is transferred to a trustee, but the transferors retain certain powers over, or interests in, the trust so that the transferors are treated as retaining direct ownership of such property for Federal income tax purposes (secs. 671-679). Thus, income, deductions, and credits of the grantor trust are attributed directly to the grantors.[2]

Indirect ownership of income producing assets

Separate taxable entities—corporations

One form of indirect ownership of income producing property is the ownership of stock in a corporation that owns such property. Corporations can be used to hold investment property or to engage in the active conduct of a trade or business.

Corporations generally are treated for tax purposes as separate taxable entities, apart from their shareholders.[3] Thus, income earned by a corporation is taxed to the corporation. In addition, when the after-tax earnings of a corporation are distributed to the corporation's stockholders as dividends, generally, such earnings also are taxed to the stockholders.[4]

Interest on debt incurred by a corporation to finance the acquisition of income producing assets generally is deductible to the corporation incurring the debt. To the extent that income from debt-financed property is paid to the debtholders in the form of interest, the interest deduction offsets any corporate level tax on such income, resulting in the imposition of only a single tax on the income, which tax is borne by the debtholder.

Complete conduit entities

Partnerships.—Another form of indirect ownership of income producing assets is ownership of an interest in a partnership holding such assets. A partnership generally is treated as a complete conduit for Federal income tax purposes.[5] Each partner accounts for his "distributive share" of the partnership's income, loss, deduction, and credit. The liability for income tax is that of the partner, and not of the partnership, without regard to whether the income of the partnership is actually distributed to the partners. Partnership losses, deductions, and credits pass through to the partners and can be used to offset other income. In general, an entity is treated as a partnership if it is an unincorporated organization through, or by means of which, any business, financial operation or venture is carried on, and it is not treated as a corporation, a trust, or an estate.[6]

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[2] In some cases, persons other than the transferors are treated as owners of the trust's assets.

[3] Certain corporations may be treated as complete or partial conduit entities, however. *See* discussion of S corporations and real estate investment trusts, below.

[4] Under present law, an individual generally is allowed to exclude from taxable income up to $100 of dividends per year ($200 for a joint return) (sec. 116). Corporations are entitled to a dividends received deduction for 85 or 100 percent of dividends received (secs. 243-245). Section 311 of H.R. 3838, the Tax Reform Act of 1985, as passed by the House of Representatives on December 17, 1985, generally reduces the two-tier taxation of income earned by corporations by granting corporations a deduction equal to 10 percent of dividends paid out of earnings that have been subject to corporate level tax. This provision is effective for dividends paid in taxable years beginning after January 1, 1987 and is phased in over 10 years. In addition, sections 303 and 312 of H.R. 3838 lower the 85-percent corporate dividends received deduction to 80 percent for dividends received or accrued after December 31, 1985, and further lower such deduction to 70 percent corresponding to the phase-in of the dividends paid deduction. Further, section 313 of H.R. 3838 repeals the dividend exclusion for individuals, effective for taxable years beginning after 1985.

[5] A partnership is treated as an entity separate from its partners for purposes of calculating items of taxable income, deduction, and credit. It also is treated as an entity for purposes of reporting information to the Internal Revenue Service.

S Corporations.—Income producing property also may be owned indirectly through ownership of stock in an S corporation. Although S corporations are corporate entities, if an eligible corporation so elects, its shareholders generally may account for a proportionate amount of the corporation's items of income, loss, deduction, and credit under subchapter S of the Code (secs. 1361–1379). The S corporation itself generally has no tax liability for as long as the election is in effect.[7]

In general, a domestic corporation may elect to be treated under subchapter S if it has 35 or fewer shareholders (none of whom are corporations or nonresident aliens), has not more than one class of stock, and is not a financial institution, a life insurance company, or one of several other types of corporations.

Partial conduit entities

Real estate investment trusts.—Another form of indirect ownership is the ownership of shares or interests in a real estate investment trust ("REIT"). Under the provisions of the Code applicable to REITs (secs. 856–860), REITs generally are treated as conduits for Federal income tax purposes to the extent of the amount of its earnings that are distributed currently to shareholders. Conduit treatment is achieved by allowing the REIT a deduction for earnings distributed on a current basis. Thus, income that is currently distributed to shareholders is not taxed at the REIT level; income that is not currently distributed to shareholders is taxed at the REIT level, as in the case of ordinary corporations.

In general, an entity may qualify as a REIT if it is a trust or corporation with at least 100 different freely transferable interests, and would be taxable as an ordinary domestic corporation but for its meeting certain specified requirements. These requirements relate to the entity's assets being comprised substantially of real estate assets and the entity's income being in substantial part realized from certain real estate and real estate related sources.

The ability of a REIT to engage in regular business activities is limited by the requirement that income from the sale or other disposition of stock or securities held for less than 1 year, or real property held less than 4 years, must account for less than 30 percent of the REIT's income, as well as certain other requirements. Further, a 100-percent tax is imposed on gains from the sale of property held for sale to customers in the ordinary course of trade or business (other than foreclosure property).

If a corporation meets these requirements and elects to be treated as a REIT, it generally is subject to the regular corporate tax, but receives a deduction for dividends paid provided that the amount of its dividends paid is not less than an amount generally equal to 95 percent of its ordinary income. These dividends must be paid within a short period following the close of the REIT's taxable year and are generally includible as ordinary income to the shareholders.[8]

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[6] *See* discussion of entity classification, below.

[7] An S corporation may be subject to tax at the entity level under certain limited circumstances.

A REIT that realizes capital gain income may be subject to tax at the corporate level at capital gains rates. If, however, the REIT pays dividends out of such capital gains, the dividends are deductible by the REIT in computing its capital gains tax and are taxable as capital gains to the recipient shareholders.

Trusts.—Another form of indirect ownership of property is ownership of the beneficial interest of property that is held in a trust. A trust is an arrangement whereby trustees take title to property and become responsible for the protection and conservation of such property on behalf of the persons holding the beneficial interest in the property. A trust (other than a grantor trust) generally is treated as a partial conduit for Federal income tax purposes since the trust, although in form a separate taxable entity, is allowed a deduction for amounts distributed to its beneficiaries, which amounts generally are includible in the beneficiaries' income.

A fixed investment trust is a trust used to hold a portfolio of investments for its beneficiaries. Generally such a trust is treated as a trust for tax purposes (and not as an association) if the trustee does not have the power to vary the investments of the trust.[9]

Rules for classifying entities

Corporation or partnership

Under present law, Treasury regulations provide that whether a particular entity is classified as an association taxable as a corporation or as a partnership, trust, or some other entity not taxable as a corporation is determined by taking into account the presence or absence of certain characteristics associated with corporations. These characteristics are (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for entity debts limited to entity property, and (6) free transferability of interests.[10] These regulations generally are based on the principle stated in *Morrissey* v. *Commissioner*, 296 U.S. 344 (1935), in which the Supreme Court held that whether an entity is treated as a corporation depends not on the form of its organization, but on whether it more closely resembles a corporate than a noncorporate entity.

Of the characteristics mentioned above, the first two are common both to corporate and partnership enterprises. Consequently, the remaining four factors are determinative of whether the entity is treated as a corporation or as a partnership. Treasury regulations state that the corporate characteristics of an entity must make it more nearly resemble a corporation than a partnership or a trust for the entity to be treated as a corporation.[11] Under this test, the Treasury regulations provide that most limited partnerships formed under the Uniform Limited Partnership Act are not treated as corporations since these entities generally do not possess continuity of life and also may lack limited liability.

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[8] A deficiency dividend procedure was added to the REIT provisions as part of the Tax Reform Act of 1976 so that a REIT, acting in good faith but failing to satisfy the distribution requirement, could avoid disqualification.

[9] *See* discussion of entity classification, below.

[10] Treas. Reg. Sec. 301.7701-2(a).

[11] *Id.*

Trust or association

Since both corporations and trusts possess centralization of management, continuity of life, free transferability of interests, and limited liability, the determination of whether a particular unincorporated entity is treated as a trust or as an association taxable as a corporation depends on whether there are associates and an objective to carry on business and divide the gains therefrom.[12] Generally, if the purpose of an arrangement is to grant to trustees exclusive responsibility for the protection and conservation of trust property, and the persons with the beneficial interest in the property cannot share in the discharge of that responsibility, there are no associates or an objective to carry on business. Such an arrangement generally will be treated as a trust.[13] On the other hand, if a trust is used for carrying on a profit-making business that ordinarily would be carried on through a business organization such as a corporation or partnership, it will not be treated as a trust.[14] However, a trust that is used to hold income producing assets may be treated as a trust if there is no power under the trust agreement to vary the investment.[15]

In 1984, the Treasury Department issued proposed regulations addressing the treatment of trusts that have more than one class of ownership interest.[16] A trust has one class of ownership if all of the beneficiaries of the trust have undivided interests in all of the trust property. More than one class of ownership may exist where, for example, some beneficiaries are entitled to receive more than their pro rata share of trust distributions in early years and other beneficiaries are entitled to more than their pro rata share in later years.

Under the proposed regulations, an arrangement having more than one class of ownership interest may not be treated as a fixed investment trust. The regulations take the position that because such an arrangement "enables investors to fulfill varying profit-making objectives through the division of rights, and the sharing of risks, in certain assets, the arrangement is considered to have associates and an objective to carry on business and divide the gains therefrom." [17] Thus, if a trust held a portfolio of mortgages or other debt obligations, and interests in the trust assets were divided so that one class of beneficiaries were to receive all principal collected by the trust and a specified rate of interest thereon, until the trust had collected a specified amount of principal, and another class of beneficiaries were to receive all remaining amounts collected by the trust, then such trust would be treated as an association taxable as a corporation under the proposed regulations. The proposed regulations would apply to interests issued after April 27, 1984.

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[12] Treas. Reg. Sec. 1.7701-2(a)(2).
[13] Treas. Reg. Sec. 301.7701-4(a).
[14] Treas. Reg. Sec. 301.7701-4(b).
[15] Treas. Reg. Sec. 301.7701-4(c).
[16] Prop. Treas. Reg. Sec. 301.7701-4(c).
[17] Prop. Treas. Reg. Sec. 301.7701-4(c)(2).

Taxation of Income From Debt Obligations

The original issue discount rules

Treatment of original issue discount as interest

If the borrower receives less in a lending transaction than the amount to be repaid at the loan's maturity, then the difference represents "discount." Discount performs the same function as stated interest, i.e., compensation of the lender for the use of the lender's money.[18] Code sections 1272 through 1275 and section 163(e) (the "OID rules") generally require the holder of a debt instrument issued at a discount to include annually in income a portion of the original issue discount ("OID") on the instrument, and allow the issuer of such an instrument to deduct a corresponding amount, irrespective of the methods of accounting that the holder and the issuer otherwise use.[19]

Definitions

"Original issue discount" is defined as the excess of a debt instrument's "stated redemption price at maturity" over its "issue price." If such excess is less than a certain *de minimis* amount the holder may treat the OID as zero.

"Issue price" is generally (1) in the case of a cash loan, the amount borrowed, (2) in the case of a debt instrument that is issued for property where either the debt instrument or the property is publicly traded,[20] the fair market value of the property, or (3) if neither the debt instrument nor the property exchanged for it is publicly traded, an amount determined using an adequate interest rate.

"Stated redemption price at maturity" includes all amounts payable at maturity excluding any interest based on a fixed rate and payable unconditionally over the life of the debt instrument at fixed intervals no longer than one year.

Operation of the OID rules

The amount of the OID in a debt instrument, if any, is allocated over the life of the instrument through a series of adjustments to the issue price for each "accrual period" (i.e., each six-month or shorter period ending on the calendar day corresponding to the date of the debt instrument's maturity and the date six months prior to the date of maturity). The adjustment to the issue price for each accrual period is determined by multiplying the "adjusted issue price" (i.e., except as may be provided by regulations, the issue price increased by adjustments prior to the beginning of the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period.

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[18] *United States* v. *Midland-Ross Corp.*, 381 U.S. 54 (1965); *see also Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134 (1974).

[19] Prior to 1982, the OID rules applied only to a limited class of obligations. The Tax Equity and Fiscal Responsibility Act of 1982, P.L. 97-248, and the Tax Reform Act of 1984, P.L. 98-369, greatly expanded the number and types of obligations to which the OID rules apply.

[20] Presently, only stock or securities traded on an established securities market are treated as publicly traded. However, section 1503(a)(10) of H.R. 3838 would grant the Treasury Department authority to issue regulations treating as publicly traded other property "of a kind regularly traded on an established market."

The adjustment to the issue price for any accrual period is the amount of OID allocated to that accrual period. These adjustments reflect the amount of the accrued but unpaid interest on the debt instrument in each period. The holder is required to include this amount as interest income and the issuer is permitted a corresponding interest deduction. The holder's basis in the obligation is increased by the amount of OID includible in the holder's income."[21] The application of the OID rules to debt obligations involving multiple payments of principal is somewhat uncertain. Additional uncertainty exists about the application of the rules where the maturity of such payments may be accelerated (e.g., based on prepayments on home mortgages that collateralize the obligation).

Gain or loss on disposition or prepayment

In general, the sale or exchange of a debt obligation that is a capital asset results in the realization of a capital gain or loss to the seller. Under section 1271, amounts received by a holder of a debt obligation, other than one issued by an individual, on retirement of such debt obligation is treated as an amount received in exchange for the debt obligation. Thus, subject to certain exceptions discussed below, if the debt obligation not issued by an individual is a capital asset, its satisfaction, either at or in advance of its maturity, generally results in the realization of a capital gain or loss measured by the difference between the amount realized and the basis of the obligation. Since section 1271 does not apply to obligations issued by individuals, repayment of a debt obligation by an individual (including prepayment) is not treated as a sale or exchange, and thus may not give rise to capital gain or loss.[22]

Capital gain treatment is also unavailable if an obligation has original issue discount and, at the time of original issue, there was an intention to call the obligation before maturity. In such a case, any gain realized on the sale or exchange (including the retirement by the issuer) of the obligation is treated as ordinary income to the extent that the gain does not exceed the amount of original issue discount reduced by the amount of original issue discount that would have been includible in the income of an original holder of the obligation (sec. 1271(a)(2)). There is no authority that directly addresses the application of this provision to corporate debt obligations that are issued with original issue discount and that are called prior to maturity upon the prepayment of mortgages in a pool that collateralizes the debt obligations.

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[21] The premise of the OID rules is that, for Federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid semiannually the lender the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income such interest which has accrued but is unpaid. The lender is then deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the "economic accrual" of interest, or interest "compounding."

[22] *See* sec. 1271(b)(1). In addition, obligations issued before July 2, 1982, by an issuer other than a corporation or a government (or political subdivision thereof) do not qualify for capital gains treatment. *See* sec. 1271(b)(2).

The market discount rules

Capital gain treatment on the sale or exchange of a debt obligation also may be denied pursuant to the so-called market discount rules. In general, under the market discount rules (secs. 1276-1278), gain on the disposition of a debt obligation that was issued after July 18, 1984, generally is treated as interest income to the extent of accrued market discount. Market discount is defined as the excess of the stated redemption price of an obligation over its basis immediately after acquisition, (provided that such excess is not less than a certain *de minimis* amount). In the case of a bond that has original issue discount, for purposes of the market discount rules, its stated redemption price is treated as the sum of its issue price and the amount of original issue discount that would have been includible in the income of an original holder.

Accrued market discount on an obligation generally is the amount that bears the same ratio to the market discount on such obligation as the number of days the taxpayer holds the obligation bears to the number of days after the taxpayer acquired the obligation until its maturity. However, the holder may elect to accrue the market discount on an obligation using a constant interest rate.[23] A holder also may elect to include accrued market discount in income annually (sec. 1278(b)). It is unclear under present law how market discount is allocated among principal payments on an obligation where such principal is paid in multiple installments.

If indebtedness is incurred to purchase or carry obligations that have market discount, interest on such indebtedness in excess of the amount of interest includible in income with respect to such obligation is deductible only to the extent that such interest exceeds the market discount allocable to the taxable year (sec. 1277). Any interest expense disallowed under this provision is allowable as a deduction in the year that the obligation is disposed of. Nevertheless, this limitation on interest deductions is not imposed if the holder elects to include market discount in income currently.

The coupon stripping rules

The separation of ownership of the right to receive any payment of principal or interest on a debt obligation generally results in the application of the "coupon stripping rules" (sec. 1286). Under these rules, the holder of a debt obligation who disposes of the right to receive certain payments on the obligation (other than a pro rata share of all payments), must allocate (on the basis of fair market value) his basis in the obligation between the portion of the debt obligation that is disposed of and the portion retained for purposes of recognizing gain or loss.

Following such a disposition, for purposes of the treatment of the holder, the retained portion is treated as a debt obligation having original issue discount equal to the excess of the amount that will be received upon payment of amounts due at maturity of such retained portion over the amount of basis allocated thereto. Similarly, a purchaser of the disposed of portion of the debt obligation is treated as having purchased a debt obligation having original issue discount equal to the excess of the amount payable upon maturity of such portion over the amount paid therefor. The original issue discount rules then govern the amount that the respective holders must include in income annually.

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[23] The constant interest rate method results in smaller amounts being treated as accrued market discount in the earlier years.

Withholding on interest paid to foreign taxpayers

In general, a 30-percent withholding tax is imposed on interest paid to foreign taxpayers (secs. 871, 881, 1441, and 1442).[24] However, the withholding tax is not imposed on interest paid on certain obligations issued after July 18, 1984 (secs. 871(h) and 882(c)). Although obligations issued by individuals generally are not eligible for the exception,[25] most mortgage related securities issued after July 18, 1984 are eligible for the exception.[26] This is true even if the mortgage related security is in the form of a participation certificate in a grantor trust, in which case, the holder is for substantive tax purposes treated as holding a proportionate share of the underlying mortgages. In such a case, however, the exemption from the withholding tax is applied only to the extent that the underlying mortgages were issued after July 18, 1984.[27]

Background and Issues

Participation certificates

Mortgage related and other asset backed securities frequently are issued in the form of "participation certificates" in a pool of mortgages or other debt obligations held by a grantor trust. Holders of participation certificates are treated as the owners of proportionate shares of the trust's assets, and are required to include in income proportionate shares of the trust's income. Holders also are entitled to deduct proportionate shares of the trust's expenses.[28]

The use of grantor trusts has certain limitations, however. First, the trustees are not permitted to actively manage the trust's assets and have only the most circumscribed reinvestment power.[29] Second, the proposed regulations effectively prevent the issuance of more than one class of beneficial interest in the trust because those regulations would require the imposition of a corporate tax on the trust's income.

Because grantor trusts may have only one class of beneficiaries, all holders of participation certificates are subject to the risk of prepayment of all or a portion of their investment, depending on the extent of prepayments of the obligations held by the trust. This inability to cater to the differing investment objectives of various investors has been a source of market dissatisfaction with these instruments.

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[24] A lower rate of tax may be imposed pursuant to a treaty.

[25] Temp. Treas. Reg. sec. 35a.9999-5(a) (Q & A 1).

[26] Temp. Treas. Reg. sec. 35a.9999-5(d) (Q & A 20).

[27] *Id.*

[28] *See* Rev. Rul. 84-10, 1984-1 C.B. 155; Rev. Rul. 77-349, 1977-2 C.B. 20; Rev. Rul. 71-399, 1971-2 C.B. 433, *amplified by* Rev. Rul. 81-203, 1981-2 C.B. 137, Rev. Rul. 80-96, 1980-1 C.B. 317, Rev. Rul. 74-300, 1974-2 C.B. 169, Rev. Rul. 74-221, 1974-1 C.B. 365, and Rev. Rul. 72-376, 1972-2 C.B. 647; Rev. Rul. 70-544, 1970-2 C.B. 6 and Rev. Rul. 70-545, 1970-2 C.B. 7, *both modified by* Rev. Rul. 74-169, 1974-1 C.B. 147.

[29] *See* Rev. Rul 75-192, 1975-1 C.B. 384.

Collateralized mortgage obligations

In addition to participation certificates in grantor trusts, many mortgage related and other asset backed securities are issued in the form of debt obligations of highly leveraged corporations that hold a portfolio of debt obligations, most frequently real property mortgages. These corporate debt obligations frequently are issued in differing maturities. The cash flow of the underlying mortgages is used to service the debt obligations, and the income of the corporation arising from the mortgages that it holds may be largely or completely offset by interest on the corporation's debt. To the extent such offsetting occurs, the income from the underlying mortgages is effectively taxed only to the debtholders. Arrangements of this sort are commonly known as "collateralized mortgage obligations" or "CMOs."

Although the ability to issue obligations of differing maturities is an advantage for this form of mortgage backed security, there also are several disadvantages. First, a corporate debt obligation and the income from such debt obligation are not among the types of qualifying assets or income for purposes of whether an entity qualifies as a REIT, even if the obligation is secured by real property mortgages.[30] In addition, such obligations do not qualify as "loans secured by an interest in real property" for purposes of a savings and loan association's ability to compute its bad debt deductions under the percentage of taxable income method.[31]

Second, where a corporation is formed for the sole purpose of holding debt obligations and issuing CMOs, in order to minimize the risk that the obligations would be treated as equity, (the distributions with respect to which are not deductible unless, for example, the corporation qualifies as a REIT), rather than as debt, the corporation must have some at least some minimal amount of capitalization. This capital, which presumably must be supplied by the transferor of the mortgages, in effect increases the cost of issuing CMOs by subjecting such additional capital to a corporate layer of tax.

Third, in order for the corporate issuer to be treated as the owner of the underlying debt obligations, rather than as a mere trustee for the debtholders, the corporation must have some reinvestment risk with respect to the underlying obligations, i.e., the debt service may not be too closely matched to the cash flow generated by the collateral. Thus, the corporate issuer may not completely transfer all reinvestment risk to the CMO holders.

Fourth, the corporate issuer must pay income tax on the difference between the interest income on the issuer's assets and the interest on the CMOs.[32]

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[30] *See* sec. 856(c).

[31] *See* secs. 593 and 7701(a)(19).

[32] Such difference may arise, for example, where the CMOs are issued with different yields and different maturities, essentially because deductions with respect to higher yield, longer maturity debt tend to be weighted toward the later years relative to lower yield, shorter maturity debt.

Other formats for issuing mortgagerelated securities

Other vehicles for investing in mortgages also suffer from certain disadvantages. While it is possible to use an S corporation to issue debt, under present law, only individuals can hold shares of an S corporation, and the maximum number of shareholders is limited to 35. REITs must have at least 100 shareholders. The ability of institutional investors to hold interests in limited partnerships may be limited under state law. Fixed investment trusts may be unattractive with respect to ownership by REITs and savings and loan associations because an interest in the trust may not be treated as a qualifying interest in real property or real property loans.

Issues

The stated purpose of the bills (S. 1959 and S. 1978) is to provide an indirect investment vehicle that does not contain the various disadvantages discussed above. However, these proposals raise a number of issues:

First, is it appropriate to create another type of conduit entity under the tax laws for investment on mortgages or other obligations? Moreover, should conduit treatment be provided for an entity that can issue several classes of securities?

Second, should only home mortgages qualify for any special treatment, or should any other debt obligations qualify as well?

Third, how should the OID and market discount rules be applied to divided interests in debt obligations?

Fourth, under what circumstances should foreign investors be eligible for the exemption from withholding tax?

Fifth, should any newly created conduit treatment apply with respect to interests created in all outstanding obligations or only newly issued obligations.

Sixth, should any or all of the interests in a newly created conduit entity be treated as real estate assets for purpose of REIT qualification, or as real property loans for the purpose of qualification for percentage bad debt deductions.

Explanation of the Bills

1. S. 1959 (Senator Chafee)

Overview

The Secondary Market Tax Amendments of 1986 ("SECTA"), S. 1959, introduced by Senator Chafee, would create a new form of mulitple class mortgage related security, known as a "collateralized mortgage security" or "CMS." Holders of the CMS would be treated as beneficial owners of the underlying mortgages. The bill would provide rules prescribing the income tax treatment of taxpayers who exchange mortgages for CMSs, the treatment of taxpayers holding CMSs, and the treatment of the disposition of CMSs. Among these rules are clarifications of the application of the OID rules to obligations the timing of whose maturities is contingent upon the timing of payments on the underlying collateral. In addition, certain new information reporting requirements would be imposed on issuers of CMSs.

Issuance of a CMS

Under the bill, a CMS may be issued in the form of an ownership interest in a corporation, association, trust, or partnership holding "qualified obligations," or as a debt obligation issued by any of the above. Regardless of the form, the issuance of a CMS generally would be treated as a sale of the collateral securing the CMS to the holders of the CMS. Thus, the initial transferor of the qualified obligations and the the entity that holds such obligations and issues that CMSs would be treated as entirely separate entities, i.e., CMSs issued in the form of debt would not be treated as debt of the transferor of the qualified obligations and, except to the extent that the transferor holds CMSs, the income generated by the underlying collateral would not treated as income of the transferor.

A CMS could represent either a "regular" or "residual" interest in the underlying collateral. A regular interest would entitle the holder to receive specified principal payments (or analagous amounts in the case of CMSs not issued in the form of debt), the timing of which principal payments would be contingent upon the timing of receipt of principal payments on the underlying collateral and the amount of income from temporary reinvestments of portfolio cash flows. A residual interest would entitle the holder to receive amounts that are contingent with respect to both timing and amount upon the extent of prepayments on qualified obligations, the amount of income from temporary reinvestment of portfolio cash flows, and the amount of contingent payments received on qualified obligations. A regular interest, unlike a residual interest, could provide for the payment of interest on the outstanding principal balance of the CMS.

Eligible collateral for a CMS

In general, in order to qualify as a CMS under the bill, a security must be collateralized either by "qualified obligations" or "permitted investments." Qualified investments would include real property mortgage loans, interests in other CMSs, participation certificates representing beneficial interests in such obligations, guaranteed investment contracts, and property acquired pursuant to the default of or the substitution for a defective qualified obligation. Permitted investments generally would include cash and cash items that either were part of the initial collateral of the CMS or were subsequently acquired under certain circumstances, and the temporary reinvestment of cash flows.

Transfers of qualified obligations

In general, the transfer of qualified obligations to a CMS issuer (i.e., the entity that holds the collateral) in exchange for cash or other property would result in recognition of gain or loss to the transferor. If qualified obligations were transfered in exchange for regular interests, no loss would be recognized, but gain generally would be recognized, except to the extent provided in regulations. If qualified obligations are exchanged for residual interests, no gain or loss would be recognized.

If qualified obligations are transfered to a CMS issuer in exchange for regular and residual interests, or either or both such interests along with cash, the basis of the qualified obligations transferred would be allocated in proportion to the fair market value of the interests (and cash, if any) received. The transferor would be permitted to elect to treat the fair market value of residual interests as zero in certain circumstances.

Treatment of holders of CMSs

Under the bill, holders of regular interests generally would be taxed as if their regular interest were a debt obligation to which the rules of taxation generally applicable to debt obligations apply. The bill, however, would provide rules clarifying the application of the OID rules to debt instruments that, as may be the case with CMSs, have a maturity that is initially fixed, but that is accelerated based on prepayments on the underlying collateral. In general, the clarified OID rules would require OID for an accrual period to be calculated and included in the holder's income based on the increase in the present value of the obligation, taking into account the amount of acceleration of the obligation's maturity attributable to prepayments during the period as well as payments received on the CMS during the period.

Holders of residual interests generally would include amounts in income when paid or credited. The holder's basis, if any, would be recovered as a deduction on a straight line basis over the estimated duration of the residual. Any gain that was not recognized by the transferor of a qualified obligation on the transfer of such obligation to the issuer in exchange for a residual interest would be taken into income on a straight line basis over the estimated duration of the residual. Regulatory authority would be granted to the Treasury Department to issue regulations that would treat residual interests more like debt obligations in certain limited circumstances.

The bill also would provide for the acceleration of the recognition of income to holders in certain circumstances. Where the cumulative amount of income recognized by all holders of regular and residual interests (under the normal rules for the recognition of interest income, the OID rules as prescribed by the bill, and the special rules for residual interests) is less than the cumulative amount of income that would have been recognized if the CMS collateral were held by a single taxable entity, then the shortfall would be allocated to the holders of regular and residual interests in accordance with a formula prescribed by the bill. Any additional income so allocated would reduce the amount of income that must be recognized in later years.

Outside premium and discount

"Outside premium" on a CMS generally would be the excess of the holder's cost (or such other amount that ordinarily would be the holder's basis immediately after the acquisition) for a CMS over the adjusted issue price of the CMS. Outside premium also could arise where loss is not recognized on the transfer of obligations to the holding entity; the outside premium would equal the unrecognized loss.

"Outside discount" on a CMS generally would be the excess of the adjusted issue price of the CMS over the holder's cost for the

CMS (or such other amount that ordinarily would be the holder's basis immediately after the acquisition). Like outside premium, outside discount also could arise in a case where gain is not recognized on the transfer of obligations to the holding entity.

Outside premium on a regular interest, to the extent it does not exceed the amount of OID with respect to such interest, would be amortized over the duration of the interest in the same proportion that the amount of OID includible for each accrual period bears to the total amount of OID. Any outside premium in excess of the amount of OID would be recovered ratably in the same proportion that the amount of principal (or similar amounts) received that year bears to the total amount of principal.

Outside discount on a regular interest would be treated as market discount. Under the bill, such discount would be recovered in the proportion that the amount of principal (or similar amounts) received bears to the total amount of principal. Such inclusions could be treated as capital gains to the extent that the underlying obligations would not be subject to the market discount rules, i.e., to the extent that such obligations were issued before July 19, 1984. If, however, at least 85 percent of the the underlying obligations were subject to the market discount rules, or at least 85 percent were not, then all of the obligations would be so treated.

Outside premium or discount on residual interests would be recovered ratably over the estimated duration of the residual.

Disposition of a CMS

In general, the disposition of a CMS would be treated like the disposition of a debt obligation. The market discount rules would be applied to determine the character of any gain recognized in the same manner as in determining the character of any recovery of outside discount upon payments of principal.

Other provisions

The bill would provide special rules relating to the accounting for expenses of issuance of CMSs, as well as ongoing expenses of the CMS issuer. In addition, the bill would impose a 100 percent tax on income from prohibited transactions, including gains from the sale or exchange of qualified obligations (with certain exceptions), and income relating to assets that are not permissible CMS collateral. The bill also would provide special rules for the sale of all of the assets of a CMS issuer and the distribution of the proceeds to the CMS holders.

The bill also would expand the interest and OID reporting requirements of present law and would apply such expanded provisions to CMSs as well as any other forms of mortgage related securities or debt obligations. Under the bill, reporting would be required with respect to interests held by corporations, registered securities or commodities dealers, RICs, REITs, and certain common trust funds. The reporting requirement also would include certain additional information relating to the taxation of any multiple class interests. CMSs would file annual information returns and would be subject to entity level audit procedures similar to those applicable to partnerships.

Effective dates

In general, the provisions of the bill would be effective after the date of enactment. An election would be provided for the application of the provisions of the bill after December 17, 1985 (the date of introduction).

2. S. 1978 (Senators Cranston, D'Amato, Dixon, and Dodd)

Overview

S. 1978 would amend the grantor trust provisions of the Code and authorize the issuance of multiple class pass-through securities by grantor trusts. Under the bill, qualifying pass-through securities would be treated as representing ownership interests in the assets, the payments with respect to which are passed through to the holders of the security.

Pass-through securities

In general, under the bill, a "pass-through security" would be a security that represents the holder's right to receive certain payments on identified qualifying "financial instruments," as well as certain other rights. Financial instrument also would include any retained beneficial interest in any financial instrument subject to such an arrangement. The interests represented by such pass-through securities could be divided into multiple classes. To qualify for the pass-through treatment, the issuance of the pass-through security otherwise must be treated as a disposition of the underlying financial instruments. Thus, the provisions of the bill would not apply to securities that otherwise would be treated as a debt obligation of the owner of the underlying financial instruments.

Where certain requirements are met, the arrangement pursuant to which the financial instruments are held would be treated as a grantor trust, and the holder of a pass-through security would be treated as having beneficial ownership in the underlying financial instruments. For example, a pass-through security would be treated as a qualifying asset for purposes of determining whether an entity meets the asset test applicable for qualification as a REIT to the extent that the financial instruments themselves would be qualifying assets.

Financial instruments

Under the bill, the term "financial instrument" generally would include most debt obligations, as well as accounts receivable, lease receivables, and the proceeds of any financial instrument and amounts earned on the temporary reinvestment of such proceeds. The term also would include an interest in a pass-through security representing an interest in such financial instruments.

Limitations

The provision of the bill would apply only if the the interests in the financial instruments were established and fixed (except with respect to attributes inherent in the underlying instruments) pursuant to the terms of the initial issuance of the pass-through security. In addition, the underlying financial instruments would have to be identified prior to the first payment on any of the pass-through securities, and substitution would be permitted within a limited period only for defective instruments.

Effective date

The provisions of the bill would apply to pass-through securities issued after April 27, 1984.

Previous Legislative Proposal

In 1983, Senators Garn and Tower introduced a bill (S. 1822, 98th Cong.) that would have created a new conduit entity for holding home mortgages, known as a "Trust For Investments in Mortgages" or "TIM." The bill provided detailed rules for the treatment of most aspects of transactions involving the creation of the TIM, the taxation of continuing holders of TIM shares, dispositions of TIM shares, and dissolution of the TIM. The bill would have permitted a TIM to issue shares in a multiple class arrangement.

B. Tax Treatment of Deductions and Credits for Expenditures in Environmental Zones

S. 1839 (Senator Chafee)

Present Law

Overview

Various tax rules provide incentives for certain types of economic development activities. These include accelerated cost recovery provisions; tax credits for specified activities; and numerous other provisions. In general, these rules (and other tax rules) apply regardless of geographic location within the United States.

Cost recovery rules

Accelerated cost recovery system (ACRS)

The Economic Recovery Tax Act of 1981 ("ERTA") enacted the Accelerated Cost Recovery System ("ACRS") for tangible depreciable property placed in service after 1980. Under ACRS, the cost or other basis of eligible property (without reduction for salvage value) is recovered using an accelerated method of depreciation over a predetermined recovery period that is generally shorter than the asset's useful life (sec. 168). (Under pre-1981 law, an asset's cost (less salvage value) was recovered over its estimated useful life (sec. 167).) The pre-1981 rules remain in effect for property placed in service by a taxpayer before 1981, and for certain property not eligible for ACRS. "Foreign use" property (i.e., property used predominantly outside the United States) is one type of property not qualifying for ACRS.

Under ACRS, the allowable depreciation deduction in each recovery year is determined by applying a statutory percentage to the property's original cost, adjusted for the investment tax credit claimed (sec. 168(b)(1)). The statutory percentages for personal property are based on the 150-percent declining balance method for the early recovery years, switching to the straight-line method. Alternatively, taxpayers can elect to use the straight-line method over the applicable ACRS recovery period or a longer recovery period, with respect to one or more classes of property placed in service during any taxable year. The statutory percentages for real property are based on the 175-percent declining balance method (200-percent for low-income housing), switching to the straight-line method. For real property placed in service after May 8, 1985, the cost of real property is recovered over a 19-year recovery period (15 years for low-income housing), although longer recovery periods may be elected.

A taxpayer (other than a trust or estate) can elect to deduct the cost of up to $5,000 of qualifying personal property in the year the property is placed in service, in lieu of recovering the cost under ACRS (sec. 179). In general, qualifying property must be acquired by purchase for use in a trade or business, and must be eligible for the investment tax credit, although no investment credit is allowed for the portion of the cost expensed under this rule. The $5,000 limit is scheduled to increase to $7,500 for taxable years beginning in 1988 and 1989, and to $10,000 for years beginning after 1989.

Provisions relating to natural resources

Intangible drilling and development costs.—Capital expenditures incurred by an operator to develop an oil, gas, or geothermal property are of two general types: (1) intangible drilling and development costs, and (2) depreciable costs.

Under present law, intangible drilling and development costs ("IDCs") either may be deducted in the year paid or incurred ("expensed") or else may be capitalized and recovered through depletion or depreciation deductions (as appropriate), at the election of the operator. (In the case of integrated producers, 80 percent of IDCs may be expensed and the remainder amortized over 36 months.) In general, IDCs include drilling-related expenditures (e.g., for labor, fuel, repairs, hauling, supplies, etc.) which are neither for the purchase of tangible property nor part of the acquisition price of an interest in the property.

Depreciable drilling costs are amounts paid or accrued during the development of a property to acquire tangible property (e.g., tools, pipe, casing, boilers, etc.) which ordinarily are considered to have a salvage value. These expenditures must be capitalized and depreciated in the same manner as ordinary items of equipment (see discussion of ACRS above), and they are treated in the same manner for both independent and integrated producers.

Percentage depletion for oil and gas (and geothermal) properties.—The costs of acquiring a lease or other interest in an oil or gas (or geothermal) property, together with certain other costs, are recovered through depletion deductions. These deductions are determined using the cost or—if available—the percentage depletion method, whichever results in a higher deduction.

Under cost depletion, the taxpayer deducts that portion of the adjusted basis of the property which is equal to the ratio of units produced and sold from that property during the taxable year to the number of units that are estimated to be recoverable from the property at the beginning of the taxable year. The amount recovered under cost depletion cannot exceed the taxpayer's basis in the property.

Under percentage depletion, 15 percent of the taxpayer's gross income from an oil- or gas-producing property is allowed as a deduction in each taxable year. The amount deducted may not exceed 50 percent of the net income from that property in that year (the "net income limitation"). Additionally, the deduction for all oil and gas properties may not exceed 65 percent of the taxpayer's overall taxable income. Because percentage depletion is computed without regard to the taxpayer's basis in a property, it may result in eventual recovery of an amount greater than the taxpayer's basis in the property.

Since 1975, percentage depletion has been limited to 1,000 barrels per day of oil production (or an equivalent amount of natural gas production) by independent producers. This rule, and the 65-percent limitation above, do not apply to geothermal deposits.

Hard minerals.—Expensing of hard mineral exploration and development costs may be elected under the Code (secs. 616 and 617), although expensed exploration costs are subject to recapture when a mine reaches the producing stage. Percentage depletion of hard mineral deposits also is provided, at rates ranging from 5 to 22 percent.

Soil and water conservation and land clearing expenses

A taxpayer engaged in the business of farming is permitted to deduct currently (i.e., expense) certain expenditures for the purpose of soil or water conservation, or the prevention of erosion, with respect to farmland. The amount deducted may not exceed 25 percent of the taxpayer's gross income from farming during the taxable year. Farmers may also expense amounts paid or incurred for the clearing of farmland, up to the lesser of $5,000 or 25 percent of taxable farming income.

Tax credits

Investment tax credit

A credit against income tax liability is allowed for up to 10 percent of a taxpayer's investment in certain tangible depreciable property (generally, not including buildings or their structural components) (sec. 46). The amount of this "regular" investment credit is based on the ACRS recovery class to which the property is assigned. The credit is generally claimed for the taxable year in which qualifying property is placed in service.

The amount of income tax liability that can be reduced by investment tax credits in any year is limited to $25,000 plus 85 percent of the liability in excess of $25,000. Unused credits for a taxable year may be carried back to each of the three preceding taxable years and then carried forward to each of the 15 following taxable years.

Special energy investment tax credits, at rates of up to 15 percent, have been provided for investments in various types of alternative energy property (including solar, wind, and geothermal property); however, these credits generally expired on (or prior to) December 31, 1985. A further special credit is allowed for certain rehabilitation expenditures.

Alternative fuels production credit

A tax credit is provided for the domestic production and sale of oil, gas, and other fuels from certain nonconventional sources (sec. 29). The credit is scheduled to expire for facilities placed in service, or wells drilled, on or after January 1, 1990.

The credit equals $3 for each barrel-of-oil-equivalent of energy produced, adjusted (except for certain natural gas) for post-1979 inflation. The credit is phased out as the annual average wellhead price of uncontrolled domestic oil rises from $23.50 to $29.50 a barrel, similarly adjusted for inflation ($32.10 and $40.30 in 1984 prices). The credit thus functions essentially as a minimum price support for fuel produced from nonconventional sources.

Capital gain rules applicable to timber, coal, and domestic iron ore

The owner of timber (or a contract right to cut timber) may elect to treat the cutting of timber as a sale or exchange qualifying for long-term capital gain treatment, even though the timber is sold or used in the taxpayer's trade or business (sec. 631(a)). (Capital gains are taxed at a maximum rate of 20 percent for individuals and 28 percent for corporations.) This provision generally requires that the timber (or contract right) be held for more than six months prior to cutting.

Royalty income with respect to timber, coal, and domestic iron ore, also qualifies for capital gain treatment, subject to a similar 6-month requirement. In the case of coal and domestic iron ore royalties, if capital gain treatment applies, the royalty owner may not utilize percentage depletion with respect to the mineral disposed of.

Industrial development bonds (IDBs)

Interest on State and local government obligations generally is exempt from Federal income tax (Code sec. 103).

Interest on industrial development bonds (IDBs) is tax-exempt only if the IDBs are issued for certain specified purposes. Industrial development bonds are obligations issued as part of an issue 25 percent or more of the proceeds of which is to be used in any trade or business carried on by a nonexempt person and the payment of principal or interest on which is derived from, or secured by, money or property used in a trade or business. "Nonexempt persons" are persons other than State or local governments or tax-exempt charitable, religious, educational, etc., organizations (described in Code sec. 501(c)(3)).

One of the exceptions under which interest on IDBs is tax-exempt is when the proceeds of the bonds are used to finance certain exempt activities. Under this exception, interest on IDBs is tax-exempt if the bonds are used to finance the following activities: (1) projects for multi-family residential rental property; (2) sports facilities; (3) convention or trade show facilities; (4) airports, docks, wharves, mass commuting facilities, or parking facilities; (5) sewage and solid waste facilities, or facilities for the local furnishing of electricity or gas; (6) air or water pollution control facilities; (7) facilities for the furnishing of water; (8) qualified hydroelectric generating facilities; (9) qualified mass commuting vehicles; or (10) local district heating or cooling facilities. In addition, interest on IDBs used to acquire or develop land as the site for an industrial park is exempt from tax.

Interest on "small issue" IDBs used for the acquisition, construction, or improvement of land or depreciable property also is generally tax-exempt. This exception applies to issues having an aggregate authorized face amount (including certain outstanding prior issues) of $1 million or less. Alternatively, the aggregate face amount of the issue, together with the aggregate amount of related capital expenditures during a 6-year period, may not exceed $10 million.

Since 1984, most IDBs (together with student loan bonds) have been subject to statewide volume limitations.

At-risk rules

Present law (Code sec. 465) provides an at-risk limitation on losses from business and income-producing activities, applicable to individuals (including members of a partnership), S corporations, and certain closely held corporations. In general, the at-risk rules are designed to prevent a taxpayer from deducting losses in excess of the taxpayer's actual economic investment (i.e., the amount which the taxpayer has "at risk") in the activity.

An exception from the at-risk rules is provided for active businesses conducted by a closely held corporation. The at-risk rules also do not apply to real estate investments and certain corporate leasing transactions.

Issues

The bill would restrict tax incentives for certain types of investment in designated environmentally sensitive areas. In particular, the intent of the bill is to limit the apparently anomalous situation in which generally applicable tax incentives encourage development in areas where development is discouraged or regulated under other Federal laws.[33] These include tax incentives for farming, energy production, and investment in depreciable property.

The definition of "environmental zones" raises several issues. The bill would restrict incentives for all activities in broad geographic areas designated in (or pursuant to) environmental statutes. The issue arises whether distinctions should be allowed between activities which may be relatively more harmful than others to a particular area. Although this could distinguish among particular projects according to their potential environmental harm, this would require a costly case-by-case evaluation of the environmental impacts of specific privately financed projects. Further, relying on environmental statutes for designating geographic areas may also leave tax determinations dependent on legislation (and regulations) originally drafted for other purposes. On the other hand, this may be preferable to the existence of potential conflicts between the tax laws and environmental policy.

The bill raises several administrative issues. For example, it would be necessary to determine the proper allocation of an investment that is located partially inside and partially outside a designated environmental zone. A similar issue arises with respect to property that moves in and out of these zones. Another administrative issue involves future designation of additional areas as environmentally sensitive (such as, for example, by expansion of the National Parks system), and the effect of that designation on current or anticipated expenditures in these zones.

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[33] *See, 131 Cong. Rec.* S15118-15119 (November 7, 1985) (statement of Sen. Chafee).

Explanation of the Bill

In general

The bill would modify the tax treatment of various items with respect to property located in environmental zones. In general, these modifications are intended to eliminate tax incentives for development in these areas. "Environmental zones" would be defined by reference to specified Federal statutes.

Definition of "environmental zone"

For purposes of the bill, an "environmental zone" would include any area (or portion thereof) located within the boundaries of an area:

(1) which is designated by the Secretary of the Interior as a critical habitat under the Endangered Species Act (16 U.S.C. sec. 1531 *et seq.*);

(2) which is authorized by an Act of Congress to be included, or designated by the Secretary of the Interior or the Secretary of Agriculture for inclusion, within the National Wildlife Refuge System, the National Park System, or the National Forest System, but which has not yet actually become subject to the laws governing management of such systems;

(3) which is a unit of the Coastal Barrier Resources System;

(4) which has been designated by the Secretary of the Interior as a national natural landmark under the Historic Sites, Buildings, and Antiquities Act (16 U.S.C. sec. 461 *et seq.*); or

(5) which has been authorized by an Act of Congress for study as a potential unit of the Wild and Scenic Rivers System, unless such area has been found by the Secretary of the Interior, after completion of such study, not to qualify for designation under the Wild and Scenic Rivers Act (16 U.S.C. sec. 1271 *et seq.*).

Cost recovery for environmental zone property

Depreciation and amortization

Under the bill, amounts paid or incurred for property used predominantly in an environmental zone would be recovered in the same manner as expenditures for property used predominantly outside the United States (sec. 168(f)). Thus, expenditures for personal property would be recovered using the double-declining balance method over ADR (i.e., pre-1981) class lives (12 years, for property having no such class life), switching to the straight-line method in the later years. Expenditures for real property would be recovered over a 35-year period using the 150-percent declining balance method, switching to the straight-line method. (Taxpayers also could elect straight-line recovery for real or personal property over the above or certain longer periods.) These recovery methods would take the place of the accelerated methods (ACRS) generally available currently for domestic property.

The election to expense up to $5,000 of certain depreciable property would be repealed for property used predominantly in an environmental zone.

Expenses relating to natural resources

Percentage depletion would be denied for oil and gas wells, mines, and geothermal deposits located in an environmental zone. These properties would be limited to utilizing cost depletion. Additionally, expensing of intangible drilling and development costs (under sec. 263(c)) and tertiary injectants (under sec. 193) would be eliminated with respect to environmental zone properties.

Soil and water conservation and land clearing expenditures

The provisions allowing farmers to expense certain soil and water conservation expenditures, and certain land clearing expenditures, would not apply with respect to land located in an environmental zone.

Effective dates for cost recovery provisions

These amendments generally would apply to amounts paid or incurred after June 30, 1986, in taxable years ending after that date. The amendments with respect to depreciation and amortization (including the denial of the option to expense certain depreciable property) would not apply to property (1) the construction or reconstruction of which began before November 7, 1985, (the date the bill was introduced) or (2) which was acquired pursuant to a binding contract between the taxpayer and an unrelated person, which contract was in effect on November 7, 1985, and at all times thereafter. Other provisions would not apply to any amounts paid or incurred before July 1, 1987, pursuant to a binding contract with an unrelated person which was in effect on November 7, 1985, and at all times thereafter.

Disallowance of tax credits for expenditures in an environmental zone

The bill would repeal the investment tax credit with respect to any property used predominantly within an environmental zone. This amendment would apply generally to periods after June 30, 1986;[34] however, an investment tax credit would remain available with respect to property qualifying for present law depreciation treatment under the bill (as described above).

The nonconventional fuels production credit (sec. 29) also would not apply with respect to sales of qualified fuels produced in (or from any property extracted or removed from) an environmental zone. This amendment would apply to sales after June 30, 1986, with an exception for binding contracts in effect between the taxpayer and an unrelated person on November 7, 1985, and at all times thereafter.

Capital gain treatment for timber, coal, and iron ore

Under the bill, the special capital gain rules with respect to timber, coal, and domestic iron ore (sec. 631) would not apply to any timber located in, or any coal or iron ore extracted from, an environmental zone. This provision would apply to sales or exchanges taking place after June 30, 1986, unless made pursuant to a binding contract between the taxpayer and an unrelated person, which is in effect on November 7, 1985, and at all times thereafter.

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[34] This effective date would be applied using the general Code principles for investment tax credit transitions (sec. 48(m)).

Industrial development bonds

No tax-exempt industrial development bonds (IDBs) could be issued to finance any facility located within an environmental zone, effective for obligations issued after June 30, 1986. Transitional relief would be provided for obligations issued pursuant to an inducement resolution adopted on or before November 7, 1985.

At-risk rules

The at-risk rules (sec. 465) would be extended to the holding of real property (as well as other investments) in an environmental zone. The at-risk exceptions for certain equipment leasing by closely held corporations and for active closely held businesses also would not apply to activities conducted within a zone. These changes would apply for losses occurring after June 30, 1986.

Grant of regulatory authority

The bill would specifically authorize the Secretary of the Treasury to prescribe such regulations as may be necessary or appropriate to carry out the provisions of the bill. These may include rules covering situations in which the computation period for any deduction includes a period during which an area is designated as an environmental zone and a period during which it is not.

Senator **Chafee**. This is a meeting of the Senate Finance Committee, Subcommittee on Taxation and Debt Management; and we are holding a hearing on three pending bills, S. 1959, S. 1978, and S. 1839.

First, we are going to have testimony on the bills involving the mortgage-backed securities, and second, we are going to explore the possibility of eliminating various tax breaks for the development of certain environmentally protected areas of our country. We have quite a few witnesses this morning—19 in fact—including my distinguished colleague, Senator D'Amato; and so, I am not going to make a lengthy opening statement.

I am delighted to see such interest in this legislation, and I look forward to hearing the testimony. We will be holding all the witnesses to the 5-minute rule. We have to enforce that in order to move on, with an exception, of course; that will not apply to either Senator D'Amato or the Treasury Department witnesses.

Now, our main purpose in having the hearing this morning is to get the legislative process moving on these issues before tax reform completely takes over the agenda of the Finance Committee. If we can come to an agreement on any of this legislation, there is still a possibility it could be added to the tax reform bill, or we could perhaps handle it separately. At least, it has a better chance of moving along because of these early hearings.

One of the important aspects of moving any legislation is that, at this time of Federal budget deficits, it not cause any loss of revenue to the Treasury. Thus, the comments of Treasury as to the revenue effects of these proposals are very important. If the Treasury cannot give us revenue estimates this morning, I hope they will do so as soon as possible since the information will play a crucial role in determining the future of these proposals.

We have before us two bills dealing with the taxation of mortgage-backed securities. My bill is 1959, and a bill introduced by Senator Cranston, 1978. Senator Cranston's bill covers not only mortgage-backed securities but securities backed by other assets as well. Now, we have a letter from Senator Cranston, who was anxious to be here, but because of a conflict in his schedule, could not be present. He does note that a more efficient asset-backed security will lower interest rates for consumers while providing a more flexible investment vehicle to pension funds, financial institutions, mortgage originators, and other investment concerns. He looks forward to working with us on this matter. So, this legislation certainly has the enthusiastic support of Senator Cranston, who regretfully could not be here because of conflicts in schedule.

Now, the bill I have is designed to clarify the tax treatment of mortgage-backed securities, which should facilitate investments in mortgages and hopefully reduce mortgage interest costs for home buyers. As has been noted, I have limited my bill to mortgages, primarily because there is more data and better understanding of how mortgages and mortgage-backed securities behave than there is of other asset-backed securities.

I am convinced that we can clarify two important tax issues with respect to these securities. First, should an entity issuing these securities be subject to a separate level of taxation? Second, what are the tax consequences to investors in these securities? If we can agree on tax rules governing mortgage-backed securities, then perhaps we could and should extend this treatment to other asset-backed Securities. However, at this point, it seems to me to be important to concentrate on making certain that the tax rules are correct.

Finally, I noticed in the written testimony that has been submitted that there is some concern that the administration may seek to exclude FNMA, Federal Home Loan Mortgage Corporation, and GNMA from issuing these securities. Now, I don't want to get into a debate this morning on that particular matter because, clearly, it is not a tax issue. However, I will say that, if the administration insists upon its position, I fear this legislation will not move forward, and I think that would be a loss to all concerned.

With regard to my bill proposing the tax incentives be eliminated for certain environmentally protected zones, I am very anxious to hear testimony on this. I serve on both this Finance Committee and the Environment and Public Works Committee. This bill is an attempt to provide consistency in the policies developed in these two committees. We should not be enacting tax incentives in the Finance Committee which would encourage development on land which we are trying to protect in the Environment and Public Works Committee. That is clearly a case of the right hand working against the left hand. Businesses who seek to develop these environmentally protected zones can still do so, but they are not going to get any help from the Federal Government in the way of reduced costs through tax breaks if the legislation I sponsor is successful.

As we all know, tax incentives cause a loss of revenue to the Federal Treasury; and as I mentioned earlier, revenue considerations are a major concern in this time of enormous Federal deficits. In the current debate over tax reform, this committee will be making some very difficult choices about whether and to what extent we can continue to provide various tax incentives to our manufacturing industries to keep them competitive internationally and thus produce more jobs in our country. Especially in this context, we should not be wasting needed revenue by providing tax incentives for unwanted development of environmentally protected areas.

In order to allow sufficient time for questions, I now would like to go to our first witness whom we welcome here, a man who has been deeply interested in this area. I am talking about the first legislation dealing with taxation of mortgage-backed securities. He is interested because, like the rest of us, he hopes it can bring down interest rates, but also he is, as you all know, a very vigorous battler for everything dealing with New York. I suspect that an industry in New York is deeply involved in the potentialities of this legislation.

So, the No. 1 battler from New York is here, and I turn it over now to Senator D'Amato. We welcome you, Senator.

STATEMENT OF HON. ALFONSE M. D'AMATO, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator D'Amato. Thank you, Mr. Chairman. Let me commend you, Senator Chafee, for calling these hearings and for introducing legislation, S. 1959, the secondary market tax amendments of 1986. I believe that your legislation is moving exactly in the right direction that we want, and it is important that we resolve this issue.

I hope that, during the hearings, we can begin to develop a legislative proposal that will provide the participants in this market with a rational tax treatment of mortgage and/or multiple asset-backed securities. The demand for multiclass passthrough securities has increased dramatically over the last few years. These securities provide benefits for investors, issuers, and the original holders of the assets behind the securities. The failure to have specific tax rules regarding the taxation of these securities seems ridiculous in light of the benefits they provide to investors, lenders, and borrowers. These individuals and entities should be allowed to invest in these securities with greater certainty regarding the tax treatment of their investments.

Both bills that we discuss today are designed to foster the growth of the mortgage-backed securities market, while S. 1978, a bill introduced by Senator Cranston and myself, additionally is designed to foster the development of a new market in asset-backed securities, including security interests in commercial real estate, equipment leases, credit card receivables, commercial loans, and automobile receivables. Just as you have, Senator Chafee, I also have indicated our hope is that this will reduce the cost ultimately in interest rates paid by consumers.

Although I cosponsored S. 1978, I realize that it does not contain a specific formula for the calculation of the tax on the securities at issue. To the extent that the issues regarding phantom profits, original issue discounts, and revenue neutrality are not adequately addressed by S. 1978, I fully intend that these issues be resolved during consideration of this bill and S. 1959. My goal in sponsoring legislation in this area stems from my desire to compel the Treasury Department to clarify existing rules or promulgate new ones regarding the tax treatment of these securities, something that they have failed to do. My colleagues and I have been prompted by Treasury's inaction in this area. The legislative proposals that we discuss today are a starting point which will hopefully culminate in the passage of legislation or the promulgation of rules that set forth a rational system of allocating taxes on these securities.

S. 1959 and S. 1978, while similar in intent, differ in their scope and approach to the taxation of multiclass asset-backed securities. The most significant distinction between the bills is that S. 1959 applies only to pools backed by mortgage-backed securities, while S. 1978 applies to many types of asset-backed securities. S. 1959 may also allow for an election procedure for debt treatment or asset treatment which would affect the taxation of the issuer. The legislation that I am cosponsoring does not change the character of present multiclass passthrough securities, but requires Treasury to promulgate rules that clarify the tax treatment of these particular instruments.

I look forward to working with Senator Chafee to inspire the Treasury to participate in the process of clarification of the tax treatment of the securities at issue. These legislative proposals are subject to modification due to the complexity of these issues, and I hope that Treasury will willingly participate in the process. Both bills would authorize the use of multiple classes of ownership in a fixed investment or a grant or trust, which are used in issuing passthrough securities. They also will harness the innovation of Wall Street to lower the cost of mortgage and consumer credit.

These new innovations in the capital markets would provide additional billions of dollars of credit to these markets and help commercial bankers—thrifts, mortgage bankers, finance companies, computer companies, and others—to reduce the cost of financing these assets. This should allow lenders to reduce interest rates on loans that they make to consumers. Such legislation is a logical next step in the development of mortgage-backed securities market following on the administration's TIMS initiative and the recent enactment and signing by the President of the Secondary Mortgage Market Enhancement Act of 1984. This legislation recognizes, however, that other new assets are now a key part of the Nation's capital market, especially the secondary markets.

Mr. Chairman, I am going to ask that the balance of my remarks be included in the record as if read in its entirety. Again, let me say that I appreciate the opportunity to appear before this committee; and I hopefully look forward to being able to work with you in developing this important legislative initiative. I think it has great, great hope in bringing down costs to businesses and ultimately to consumers.

Senator CHAFEE. Thank you very much, Senator, for taking the time to come here and submit your statement. I know you have a busy schedule; so if you have other duties, don't feel compelled to remain, and we are delighted that you were able to come.

Senator D'AMATO. Thank you, John.

Senator CHAFEE. I also would submit at this time for the record a statement by Senator Cranston on this matter and the letter that he wrote to me this morning; and also a statement by the Working Group on the Taxation of Mortgage Related Securities. This was a fine group of lawyers and others from the investment field that came up and helped us a great deal in this legislation. I would submit that for the record, plus a telegram from Mr. Rolph, vice president, tax legislation, Citibank, supporting the legislation.

Now, we will move on to our first panel, consisting of—oh, excuse me, Mr. Ross.

[The prepared statements of Senator D'Amato, Senator Cranston, the Working Group on the Taxation of Mortgage Related Securities and the telegram from Mr. Rolph follow:]

STATEMENT OF THE HONORABLE ALFONSE M. D'AMATO
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

JANUARY 31, 1986

I appreciate the opportunity that my colleague Senator Chafee has afforded those of us who are interested in resolving the complex issue of taxing multiple class pass through asset-backed securities. Senator Chafee has introduced legislation (S. 1959, The Secondary Market Tax Amendments of 1986) that offers one method of taxing these securities while Senator Cranston and I have introduced legislation (S. 1978, The Recovery Act for Mortgage and other Asset-Backed Securities) that offers another solution to the problem.

I hope that during this hearing we can begin to develop a legislative proposal that will provide the participants in this market with a rational tax treatment of mortgage and/or multi asset-backed securities. The demand for multi-class pass through securities has increased dramatically over the last few years. These securities provide benefits for investors, issuers and the original holders of the assets behind the securities. The failure to have specific tax rules regarding the taxation of these securities seems ridiculous in light of the benefits they provide to investors, lenders and borrowers. These individuals and entities should be allowed to invest in these securities with greater certainty regarding the tax treatment of their investments.

Both bills that we discuss today are designed to foster the growth of the mortgage-backed securities market while S. 1978 additionally is designed to foster the development of a new market in asset-backed securities, including security interests in commercial real estate, equipment leases, credit card receivables, commercial loans, and automobile receivables.

Although I co-sponsored S. 1978, I realize that it does not contain a specific formula for the calculation of the tax on the securities at issue. To the extent that the issues regarding phantom profits, original issue discount and revenue neutrality are not adequately addressed by S. 1978, I fully intend that these issues be resolved during consideration of this bill and S. 1959. My main goal in sponsoring legislation in this area stems from my desire to compel the Treasury Department to clarify existing rules or promulgate new ones regarding the tax treatment of these securities. My colleagues and I have been prompted by Treasury's inaction in this area. The legislative proposals that we discuss today are a starting point which will hopefully culminate in the passage of legislation or the promulgation of rules that set forth a rational system of allocating taxes on these securities.

S. 1959 and S. 1978 while similar in intent differ in their scope and approach to the taxation of multi-class asset-backed securities. The most significant distinction between the bills is that S.1959 ~~Senator Chafee's bill~~ applies only to pools backed by mortgage-backed securities while S. 1978 applies to many types of asset-backed securities. S.1959 ~~Senator Chafee's bill~~ may also allow for an election procedure for debt treatment or asset treatment which would affect the taxation of the issuer. The legislation that I am co-sponsoring does not change the character of present multi-class pass through securities but requires Treasury to promulgate rules that clarify the tax treatment of these particular instruments. I want to work with Senator Chafee to inspire the Treasury to participate in the process and clarify the tax treatment of the securities at issue. These legislative proposals are subject to modification due to the complexity of these issues and I hope that Treasury will willingly participate in the process.

Both bills would authorize the use of multiple classes of ownership in fixed investment or grantor trusts which are used in issuing pass through securities. They also will harness the innovation of Wall Street to lower the cost of mortgage and consumer credit. These new innovations in the capital markets would provide additional billions of dollars of credit to these markets and help commercial bankers, thrifts, mortgage bankers, finance companies, computer companies and others to reduce the cost of financing their assets. This should allow lenders to reduce interest rates on loans they make to consumers.

MOREOVER, to minimize the uncertainty surrounding the taxation of these securities, the legislation should contain provisions that would:

(1) authorize the issuance of multiple class pass through securities within a grantor trust;

(2) permit the use of non-mortgage assets in multiple class pass throughs; and

(3) PROVIDE the federally sponsored agencies access to the same benefits as the private market in the area of multiple class pass throughs and their taxation.

Such legislation is a logical next step in the development of the mortgage-backed securities market following on the Administration's Trusts for Investment in Mortgages ("TIMS") initiative and the recent enactment and signing by the President of the Secondary Mortgage Market Enhancement Act of 1984. This legislation recognizes, however, that other new assets are now a key part of the nation's capital markets, especially the secondary markets.

The Recovery Act for Mortgage and other Asset-Backed Securities is a response to the efforts of securities firms that have devised a marketing device that was utilized by them on certain mortgage-backed bonds, called "collateralized mortgage obligations". Subsequently these firms attempted to apply this marketing structure to pass through securities. The Treasury Department, however, on May 2, 1984, proposed restrictive amendments to its regulations on classification of investment arrangements with multiple classes of ownership. This legislation would help the Treasury distinguish the use of multiple class pass through securities from restrictions proposed by Treasury on other investment arrangements where the Treasury was concerned about tax deferral or tax avoidance use of trusts with multiple classes of ownership.

During hearings held by the Treasury Department's Internal Revenue Service on its proposed regulations in this area, the Mortgage Bankers Association of America, the Public Securities

Association, the National Association of Home Builders and others testified and supported the concepts we have embodied in this legislation.

These proposals are intended to be revenue neutral and would merely eliminate roadblocks to more efficient capital markets. They will benefit consumers by causing interest rates to decline, assist in the continued recovery of the housing industry, and provide additional liquidity and efficiency in the lending operations of any lender who securitizes assets. I therefore urge my colleagues to support our efforts to work with the Treasury on an issue of vital importance to investors, lenders, borrowers and consumers.

Again, I appreciate the opportunity to appear before this Subcommittee and look forward to developing legislation that provides for the rational taxation of multi-class asset-backed securities.

STATEMENT
OF
HONORABLE ALAN CRANSTON
UNITED STATES SENATOR
STATE OF CALIFORNIA
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
S. 1978 AND S. 1959
TAX TREATMENT OF MORTGAGE AND OTHER ASSET-BACKED SECURITIES

JANUARY 31, 1986

Mr. Chairman and Members of the Subcommittee, thank you for the opportunity to express my views on legislation before the Subcommittee on the tax treatment of mortgage and other asset-backed securities.

On December 18, 1985, I introduced along with Senators, D'Amato, Dixon, Dodd, Mattingly and Reigle S. 1978, entitled the "Recovery Act for Mortgages and Other Asset-Backed Securities". This legislation is designed to eliminate impediments to the growth of the mortgage-backed securities market and to permit the development of the new asset-backed securities market. This bill would amend the Internal Revenue Code to permit the issuance of multiple class passthrough securities backed by pools of mortgages or other assets under the grantor trust rules of the Internal Revenue Code. Other assets include consumer loans, commercial real estate mortgages, and commercial leases.

The secondary mortgage market provides billions of dollars in credit each year to finance home ownership by enabling originators of home mortgages such as thrift institutions and mortgage bankers to resell mortgage loans to investors in the form of mortgage backed securities. Recently, the first such securities backed by automobile receivables and consumer loans have come to market. An efficient secondary market lowers the cost of funds for that particular market, making it possible for originators: To make mortgage funds available to homebuyers at lower interest rates, to make car loans available at lower cost and, make other types of consumer loans available at lower cost. Under this proposal originators of all types of loans or assets will be able to sell loans or assets in a more efficient manner to other investors for cash and use the new funds to continue the lending process.

There is approximately $300 billion of outstanding mortgage securities in the secondary market. Purchasers of mortgage backed securities include banks, thrift institutions, pensions and other retirement funds, insurance companies and other institutional as well as individual investors. The first issuance of securities backed by pools of mortgages ever accomplished was done under title 8 of the Housing Act of 1968 by the Federal National Mortgage Association (FNMA). One of my constituents from California, Ray Lapin, the First President of FNMA while it was still a part of the U.S. Deparment of Housing and Development, devised the concept of putting the full faith and credit of the U.S. Government behind securities backed by pools of FHA-VA mortgages. The success of those securities led to the development of the secondary market as we know it today. Mr. Lapin can truly be said to be the "father" of the secondary mortgage market.

Since that time, the secondary mortgage market has developed a variety of mortgage-backed securities that have been attractive to investors in terms of safety, yield, and investment performance. However, because residential mortgages are subject to prepayment at uncertain intervals, the traditional mortgage security lacks call protection-assurance that the investment will have a definite maturity. The lack of call protection-from a cash payment occurring before the stated maturity to the investor-causes investors to demand a higher yield on moneys invested in these securities. This higher cost of funds is passed on to homebuyers and other participants in the market.

Many investors have differing timing needs in structuring their investments. If one pool of mortgages could be structured to pay off on several maturity dates, that is - 2 years, 5 years, 10 years et cetera-investors could select the maturity date most compatible with their investment needs. This concept is call the multiple class mortgage-backed passthrough. This multiple class feature would add more predictability to this instrument thereby reducing the demand for higher yields on these securities.

Presently the tax laws, most of which were enacted prior to the development of mortgage-backed securities, have made it difficult to structure securities that provide call protection, as well as securities that rearrange the cash flows from mortgages to create different maturity classes.

The fixed investment trust vehicle, traditionally used to market pools of mortgages in securitized form without tax liability at the pool level, has been interpreted to restrict the flexibility necessary to provide call protection even to a limited extent and the ability to structure different classes of investors with different maturities as defined by proposed treasury section 301.7701-4(c) published in the Federal Register on May 2, 1984. In early 1984, Sears Mortgage Securities Corporation along with Dean Witter pioneered the development of a multiple class, mortgage-backed passthrough security. The security was set up under the grantor trust rules with multiple classes of ownership and consistent with private letter rulings from the Internal Revenue Service. Two months later the IRS promulgated draft regulations that espoused the view that multiple class shares in collateral pools violate the passive requirement of the grantor trust form. However, the initial Sears/Dean Witter issue was grandfathered. A public hearing was held by the IRS on the proposed regulation on July 31, 1984. At that hearing, numerous witnesses, including the Public Securities Association, the Mortgage Bankers Association of America, the National Association of Home Builders, Sears Mortgage Securities Corp., Dean Witter Reynolds Inc., Norwest Mortgage Co., the Lomas & Nettleton Co., the First Boston Corp., Salomon Bros., and the gentleman from Texas, Congressman Steve Bartlett, all testified in opposition to the regulation. The witnesses described the negative effect of the regulation on the mortgage-backed securities market, and why the use of multiple class fixed investment trusts should be differentiated from Treasury concerns regarding other tax deferral investment proposals.

The Bankers Association of America testified:

We cannot overemphasize the importance of multiclass mortgage passthrough instruments to all parties involved.

We find no legal or tax rationale for the consequences of these regulations that would treat certain multiclass mortgage passthrough arrangements as a 'corporation' instead of a trust for tax purposes.

The Public Securities Association stated:

From a public policy perspective, the use of multiple class passthrough custodial arrangements are desirable because investments in traditional 30-year mortgage passthrough secruities are somewhat limited, and this new structure, by providing various maturities, will attract many new institutional investors to participate in the mortgage-backed securities market.

We can conceive of no reason why it is sound tax policy, or sound public policy, to pursue adoption of the proposed amendments without a specific exception permitting multiple class mortgage passthrough arrangements to be classified as fixed investment trusts, and not associations taxable as corporation.

The National Association of Home Builders stated:

The recent development of multiple maturity mortgage investments has been extremely beneficial for the housing industry and American homebuyers.

Mortgage-backed securities, the principal tool for raising mortgage money in the capital markets, have had higher yields than other similar investments because of the unpredictable prepayment of the underlying mortgages which makes management of mortgage passthrough portfolios more difficult than for other similar investments. The development of multiple clss mortgage investments has substantially reduced the investment risk problems associated with direct investment in mortgage-backed securities. These multiple class investments, by virtue of more predictable maturities, typically have had sinificantly lower yield requirements than other mortgage-backed securities.

Dean Witter Reynolds, Inc./Sears Mortgage Securities Corp. stated:

...offering 'fast-pay-slow-pay' interests in mortgage pools is desirable, because the different interests have different investment characteristics and appeal to different classes of investors.

We think it is wrong as a matter of legal analysis and tax policy not to exclude multiple class mortgage-passthrough arrangements from the amendments proposed...

Since the Treasury hearing in 1984, additional letters of support for the multiple-class mortgage backed passthrough have been received. All seek to have clarification of the tax questions surrounding this issue. The text of several letters to follow:

Mortgage Bankers
Association of America
Washington, D.C.
July 31, 1985

Honorable Alan Cranston,
U. S. Senate
Washington, D. C.

Dear Senator: As you know, the Mortgage Association of America has been most interested over the past several years in the development of a multiple class mortgage-backed pass-through security that would not be subjected to the restrictions embodied in the grantor trust tax treatment under the Internal Revenue Code. We view this mechanism as an excellent opportunity for the attraction of needed additional investment capital for one of our country's most important goals-creation and maintenance of an adequate national stock of housing.

We are most pleased that you are in the prcess of crafting legislation, the "Mortgage-Backed Securities Legislative and Regulatory Improvements Act of 1985," that would quthorize the creation of such a security. We would be happy to work with you and your staff in exploring the effect your proposal would have on the market and in offering any possible technical drafting assistance. And, of course, at such time as Congressional hearings might be scheduled on the subject, we would very much appreciate the opportunity to appear and testify in support of the concept.

We understand that a group of investment firms has designed a similar proposal and have also indicated to them our interest and support in this matter.

Our goal, of course, is the development of the most effective instrument that could be put in place as quickly as possible. We would hope that all interests involved in this effort could agree on a mutually satisfacory course of action.

Sincerely,

National Council of
Savings Institution
October 7, 1985

Honorable Alan Cranston,
Senate Hart Office Building
Washington, D. C.

Dear Senator Cranston: On behalf of the National Council of Savings Institutions. I would like to offer some observations on draft legilation prepared by your staff entitled the "Recovery Act for Mortgage-Backed Obligations" (RAMBO).

This legislation recognizes that tremendous change has happened in the mortgage markets in the past five years. The liquidity of mortgages has increased substantially, and the volume of trading in mortgages and mortgage-related investment vehicles has also grown.

Not only has the use and volume of mortgage-backed securites grown over the past decade, the creativity applied by the market to these instruments has mushroomed. Savings institutions now use mortgage-backed securities in their asset management. As the need to put old loans in portfolio to use, savings institutions are issuing collateralized mortgage obligations, morrgage-backed bonds and preferred stock. In the majority of these transactions, mortgage-backed securities, not the mortgages themselves, are used as the collateral.

However, the ability to best utilize mortgage-backed securities, both from the investor and issuer point of view is hampered by tax law. The passive management requirements imposed by the grantor trust provision of the tax code have limited mortgage backed securities. Your legislation addresses this fundamental weakness in the current structure for mortgage-backed securities.

At the present time, we would like to reserve our technical comments on your legislation. However, we would like to express our support for your efforts and urge that you introduce legislation in this important area.

Kind Regards

John H. Rousselot

American Bankers Association
Mortgage Bankers Association
of America
National Association of Home
Builders, National Association
of Realtors, National Council
of Savings Institutions
October 17, 1985

Honorable Bob Packwood,
Chairman
Committee on Finance,
U. S. Senate
Washington, D.C.

Dear Mr. Chairman:

It is our understanding that legislation is currently being drafted that would amend the tax laws to permit the issuance of multiple-class securities backed by a single pool of mortgages.

The undersigned organizations strongly support proposals that would remove tax liability at the pool level for multiple-class mortgage pass through securities set up under specified guidelines. With these tax law amendments, multiple-class pass through securites could be issued that would resemble collateralized mortgage obligations (CMOs) and offer investors a choice of maturities. This would lessen the unpredictability of prepayments and permit issuers to sell mortgage assets at higher prices than can be commanded by using secondary market instruments currently available to them. Thus, issuers could have the benefits of CMOs as well as ale-of-asset treatment for accounting purposes. In turn, homebuyers would realize a benefit in terms of lower interest rates that would result from more favorable secondary market pricing. Indications are that any revenue loss to the Treasury would be negligible.

We, therefore, respectfully urge Congress to hold hearings on this matter and to pass legislation that would authorize these types of multiple-class mortgage securities. Such legislation would expand the universe of investors willing to purchase mortgage products because such securities could be fashioned to accommodate differing investment needs. Pricing benefits would accrue to homebuyers in the form of lower interest rates and there would be no significant loss to the Treasury.

Sincerely,

James C. Cairns,
President,
American Bankers Association,

Ronald F. Poe
President,
Mortgage Bankers Association of America,

John J. Koelemij,
President,
National Association of Home Builders,

David D. Roberts
President,
National Association of Realtors,

Kenneth F.X. Albers
Chairman of the Board,
National Council of Savings Institutions

Treasury could make final its regulations by the end January 1986 on these issues, however, from my conversation with them, they have indicated that they will not substantially amend the regulations with respect to mortgage-backed securities trusts to allow the use of multiple class passthrough securities. They have given indications that they would like some guidance from the Congress on this matter. I believe this legislation would provide such guidance.

My bill simply overrides the proposed draft regulations prohibiting multiclass passthrough securities under the grantor trust rules. This proposal provides that multiclass passthrough securities that do not have active management features are considered within the grantor trust rule.

My legislation makes clear that all passthrough securites representing an interest in the same pool of assets must be issued simultaneously, and the interests represented thereby may not be changed after issuance. This does not, however, prevent the passing through of any adjustments inherent in the assets themselves, such as an adjustable interest rate or a prepayment of principal. Furthermore, the pool of assets must be fixed prior to the date of the first payment to security holders, except for a 2 year period in which substitution of substantially similar assets is allowed in connection with a breach of a representation or warranty made by the transfer of the assets to the trust. I believe that these restrictions provide protection against any tax deferral securities being issued under this provision, that such minor acts described above don't violate the active management prohibition under the grantor trust rule because the terms of the trust cannot be intentionally changed after inception by an act of the trustee.

The bill contemplates that passthrough securities may be issued in one or more classes. A class is defined to include one or more classes. A class is defined to include one or more passthrough securities, each of which represents a pro rata right to specified cash payments and other rights provided for in the indentified assets. For example, a class may represent an undivided interest in all of the assets of the trust; an undivided interest in all of the assets of the trust; an undivided interest that differs from another class of undivided interests in that its right to payments on the assets is senior to or subordinate to such other class in the event of a delinquency or default on an underlying asset; or a sequential-"fast pay" or "slow pay" interest which receives payments of principal or similar amounts- on the assets prior to or later than another such interest together with amounts designated as interest.

The assets which may be owned through a grantor trust are as proposed in the bill described as "financial instruments." These are defined to include: First, any evidence of indebtedness, such as residential or commercial mortgage, automobile loan, commercial bank loan, credit card receivable, or trade receivable; second, any lease receivable, third, any proceeds of a financial instrument, temporary investments of such proceeds and any income thereon, and any property acquired pursuant to foreclosure-or similar realization on a security interest-with respect to any financial instrument; and fourth, any other passthrough security. Proceeds of a financial instrument include any payment thereon or an payment in lieu thereof, such as advances, guaranty payments, insurance proceeds, or foreclosure proceeds. The bill would be effective with respect to passthrough securities issued after April 27, 1984, the effective date of proposed Treasury regulation section 301.7701.4.

The multiclass format has historically been used predominantly for mortgages. However, the securitization of nonmortgage assets, a relatively recent development, was not consciously excluded from early efforts to facilitate the securitization of mortgages. It simply was not in existence.

It would be incongruent to divide the capital markets by permitting one form of assets, mortgages, to be securitized versus other types of assets. Although homeownership is an important goal for many Americans, food, clothing, home furnishings, automobiles, and other consumer items are generally viewed as equally essential necessities. I believe that there is merit to including consumer loans, commercial mortgages, leases and other assets because this could have a substantially beneficial impact on consumers, business, and financial institutions. This is an area that deserves greater attention by the Congress and the Treasury.

For instance, finance companies, thrifts, and commercial banks that are holders of consumer loans will have a format to sell those loans and remove some of the risk inherent in consumer lending, such as student and education loans. Creating a more efficient capital market is one way to lower interest rates on credit card loans in response to continued consumer complaints that credit card interest rates are too high. Second, the securitization of commercial leases will be beneficial to computer companies as a means to raising capital for expansion by securitization of their equipment leases. Commercial banks for example, should benefit by being able to securitize and sell commercial loans and commercial real estate loans to investors more economically. This should add liquidity and new sources of fee income for these institutions. Mortgage bankers who are unable to withstand increased debt burdens on their balance sheets should benefit greatly from obtaining sale-of-asset treatment for securitization of commercial and residential mortgages. Thrifts, which in recent years have been the hardest hit by the high cost of financing their assets, should benefit greatly as well by having a new asset liability mangement tool. This legislation will also provide them new sources of fee income and it will mitigate against loan losses on commercial and consumer loans as they diversity into these new lending areas. Domestic automobile companies have found in recent years that less costly financing alternatives offered by their finance company subsidiaries have been largely responsible for increased purchases of automobiles and have helped revitalize the automobile industry. The inclusion of automobile receivables as qualifying assets will help them substantially. It is also my belief that asset-based passthrough financings will be of substantial benefit to many other companies that are highly leveraged and/or cannot support additional debt burdens on their balance sheets. Indeed, several prominent financial commentators have argued that excessive debt burdens are endangering American corporations. This security can be used to provide asset liability management and improve the ratio of equity to debt of many corporations. Additionally, those Government sponsored agencies that sell mortgages such as Ginnie Mae, Fannie Mae, and Freddie Mac, will certainly benefit from the multiclass mortgage backed passthrough structure as it will lower their cost of funds.

My bill is a middle ground approach that I think the Treasury with some modification could find acceptable because it does not create any new instruments. Therefore, the ideological issues raised in the previous bill Trust In Mortgages (TIMs) and on S. 1959 before the Committee today as to whether government sponsored credit agencies such as the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) should have access to any new investment vehicles does not arise. My bill simply clarifies and expands the existing instrument being used in the secondary market. I want to make it clear, however, that I am fully supportive of S. 1959, the Chairman's bill in that it attempts to resolve the taxation questions surrounding Original Issue Discount (OID) on collateralized Mortgage Obligations (CMOs). I did not attempt to address this issue in my bill because of its complexity. The Chairman has a formula for taxing OID on a current basis in his proposal. I seek guidance from the tax experts at Treasury on this issue, recognizing that there could be any number of formulas that could be used to clarify this question that would fit into our current tax policy as well as the formula in this proposal. If this formula is acceptable, I see no problem with merger of these two bills and moving forward on this approach.

Additionally, S. 1959 creates a new instrument which all government sponsored agencies would have access, of which I am fully supportive. I do not believe that there is any logical argument for exclusion of FNMA or other government sponsored agencies from using any new instruments as long as the investment activity is permitted under the Charter of those agencies. Any such effort by the Administration will be viewed as an unfounded attempt to undercut the safety net for low and moderate income housing that FNMA, GNMA and FHLMC have made possible for millions of Americans by legislative decree of the Congress.

Additionally, not to allow the use of a multiclass security under the grantor trust format for non mortgage loans or assets will deprive consumers of the benefit of a more efficient security while creating yet another level of complexity by requiring regulators and investors to treat otherwise very similar assets differently. To not clarify the application of the Internal Revenue Code to the fullest extent possible is counterproductive to the overall tax simplification efforts presently being undertaken by the Congress and Administration. While it is clear that the Treasury could proceed with authorizing a multiclass mortgage-backed passthrough, this is too important an area with broad public policy implications to be left solely to the Treasury.

This area has been in limbo since the proposed Treasury regulations were issued in early 1984. These regulations have never been made final. It is recognized that any change in the way business is done could have tax implications.

However, because the Treasury has not spoken on these matters, the market has created other instruments such as the collateralized mortgage obligations to carry out this activity. This particular mechanism is an inefficient one and therefore a more costly one. If there are tax problems created by these instruments, it is time that Treasury stepped forward to propose a solution so that business in this important area of the capital market can go on in an orderly manner.

The secondary market is now a large market with broad-based participation. Private entities such as General Mortors Acceptance Corp., the General Electric Credit Corpo., Ford Motor Credit Corp., and Chrysler Financial Corp., are now all active participants in the secondary market. The growth of this market is being restrained by anachronistic tax laws and in some cases the application of laws that have no relevance to market activity. Now is the time for the Congress to begin the process of providing a unified framework for the future development and growth of the mortgage and asset-backed securities market to the benefit of consumers, underwriters, and issuers, both private and publec.

I look forward to working with the Chairman and the Administration in resolving the issues raised by these two proposals.

JAKE GARN, UTAH, CHAIRMAN
JOHN HEINZ, PENNSYLVANIA
WILLIAM L. ARMSTRONG, COLORADO
ALFONSE M. D'AMATO, NEW YORK
SLADE GORTON, WASHINGTON
MACK MATTINGLY, GEORGIA
CHIC HECHT, NEVADA
PHIL GRAMM, TEXAS
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ALAN J. DIXON, ILLINOIS
JIM SASSER, TENNESSEE
M. DANNY WALL, STAFF DIRECTOR
KENNETH A. McLEAN, MINORITY STAFF DIRECTOR

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510

January 30, 1986

The Honorable John H. Chafee
Chairman
Subcommittee on Taxation and Debt
Management of the Senate Finance Committee
U. S. Senate
Washington, D.C. 20510

Dear ~~Mr. Chairman:~~ Al—

Unfortunately because of a conflict in my schedule I cannot be present for the hearing today on our bills S. 1978 and S. 1959 that deal with the tax treatment of mortgages and other asset-backed securities. However, I would like to have my statement inserted in the record.

As you know, our two bills address some similar and non-similar aspects of the secondary market. I have no doubt that these differences can be resolved among ourselves and with the Administration. I would like to commend my collegue for taking time out from his busy schedule on tax reform to focus on these issues.

I am convinced that a more efficient asset-backed security will lower interest rates for consumers while providing a more flexible investment vehicle to pension funds, financial institutions, mortgage originators and other investment concerns.

Hopefully, the strong expression of support for legislative action on this subject from both the Banking and Finance Committees of the U.S. Senate will be matched by a cooperative spirit from the Administration. I look forward to working with you.

Sincerely,

Alan Cranston

THE WORKING GROUP ON THE
TAXATION OF MORTGAGE-RELATED SECURITIES

January 30, 1986

The Honorable John H. Chafee
Chairman, Subcommittee on Taxation
 and Debt Management
United States Senate
SD-567, Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

We wish to commend you for introducing S. 1959, The Secondary Market Tax Amendments of 1986, and for scheduling early hearings on this important legislative initiative.

The unique payment characteristics of mortgages and mortgage related securities present a series of tax issues that have never been the subject of comprehensive legislative or regulatory review. Moreover, the tax rules that have evolved have failed to keep pace with rapid changes in the financial markets that have occurred in recent years. As a result there is substantial tax uncertainty and a serious potential for anomalous tax results that should be of concern to the Treasury Department and the Congressional tax writing committees.

The importance of the secondary mortgage market cannot be doubted. In 1970, there were less than $1 billion of outstanding publicly issued mortgage backed securities. By the end of 1985, there were almost $400 billion of such securities outstanding, a market almost as large as the total corporate debt market.

This meteoric growth has been accompanied by the rapid development of innovative securities. One such security, known as a collateralized mortgage obligation, was first issued publicly in June of 1983. Despite its novelty, over $30 billion have been issued in the last 2½ years, with more than $1 billion currently being issued each month. This security has created important benefits for the secondary mortgage market, and has clearly helped to reduce the cost of homeownership in this country. Nevertheless, there remain technical problems and uncertainties surrounding its tax treatment, which must be resolved before its full economic benefits can be realized by homeowners.

Over the last several months we have been meeting as a working group to develop legislative recommendations that would resolve existing tax uncertainties in a manner consistent with what we believe are sound and sensible tax principles. The product of our working group's collective efforts is a series of technical recommendations which we have been fortunate to have the opportunity to present to you and your staff. Your bill, the Secondary Market Tax Amendments of 1986, embodies the key aspects of our recommendations in legislative language.

The working group was convened by Andrew E. Furer, who served until September of 1984 as Associate Tax Legislative Counsel of the Treasury Department. The group was principally comprised of tax practitioners with substantial experience in structuring secondary mortgage market transactions. The principal draftsman of the materials describing and explaining the group's proposal was Donald B. Susswein, who served until January 1985, as Tax Counsel to the U.S. Senate Finance Committee.

As the product of a consensus process, our recommendations do not necessarily reflect how each member of the group might individually resolve the various technical issues addressed by the proposal. Nevertheless, as a group we endorse the proposal as a sound approach to the taxation of mortgage backed securities. The proposal is designed to be revenue neutral, with some possibility of revenue gains attributable to increased tax compliance from the proposal's new information reporting requirements.

We look forward to continuing to work with you and your staff and the other tax writing staffs to develop non-controversial, technical legislation to resolve the uncertainties and anomalies in this area of the tax law. In our view, the enactment of such legislation merits the interest and support of the tax-writing committees, much like the series of technical tax simplification bills Congress has passed over the last few years dealing with Subchapter S corporations, installment sales, and other issues.

Sincerely,

The Working Group on the Taxation
of Mortgage-Related Securities

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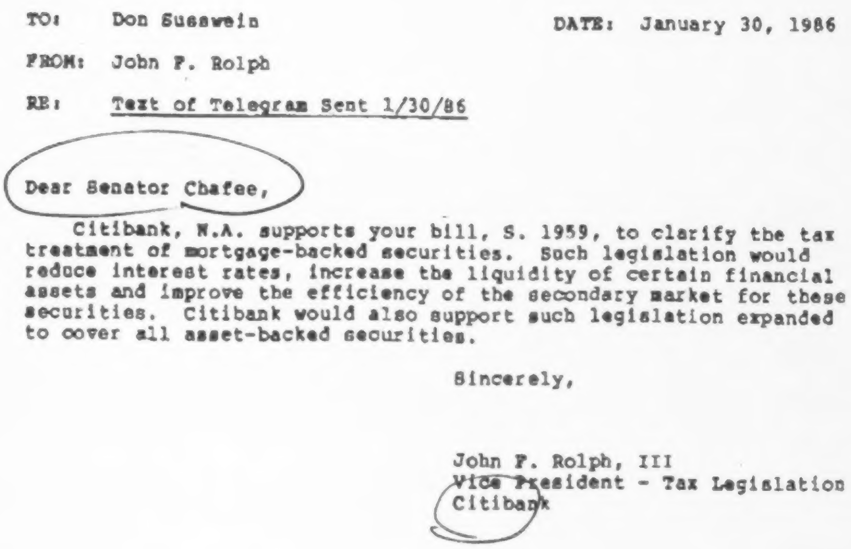

TO: Don Susswein DATE: January 30, 1986

FROM: John F. Rolph

RE: Text of Telegram Sent 1/30/86

Dear Senator Chafee,

Citibank, N.A. supports your bill, S. 1959, to clarify the tax treatment of mortgage-backed securities. Such legislation would reduce interest rates, increase the liquidity of certain financial assets and improve the efficiency of the secondary market for these securities. Citibank would also support such legislation expanded to cover all asset-backed securities.

Sincerely,

John F. Rolph, III
Vice President - Tax Legislation
Citibank

Senator CHAFEE. Mr. Ross, we welcome you, the most important witness today, as a matter of fact. Everybody had better listen carefully to what he has to say.

I will start off by saying this is a complicated field; and I myself am trying to become more knowledgeable in it. I have just learned some of the terms—CMO's, CMS, SECTA, RAMBO, yield curves, original issue discount—so I might slow people down on occasion to ascertain what they are talking about.

Why don't you go to it, Mr. Ross? I am glad you are here. I spoke to others from the Treasury Department. Roger Mentz indicated he wished to be here, but I believe he is in Europe. We are delighted that we were able to get you to come as a witness.

STATEMENT OF DENNIS ROSS, TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. ROSS. Thank you, Mr. Chairman. I am pleased to have the opportunity to present the Treasury Department's views on S. 1959 which, as you indicated, addresses the tax treatment of issuers and holders of multiple-class mortgage pools; S. 1978, which also addresses the tax treatment of multiple-class mortgage pools, but as well, the tax treatment of pools of various other debt instruments; and finally, S. 1839, which would limit the tax incentives available for activities conducted in zones designated as environmentally sensitive.

Mr. Chairman, let me turn first to the question of multiple-class mortgage pools. Mr. Chairman, the basic message I bring to you with regard to S. 1959 and S. 1978 is that Treasury commends and supports the efforts of this subcommittee to provide clear rules for the tax treatment of multiple-class mortgage pools. Uncertainty under current law has effectively denied access to the secondary market for some issuers. Moreover, this existing uncertainty may result in a significant mismatch of the reported income holders of interests in multiple-class mortgage pools and the corresponding deductions of issuers, as well as the conversion for holders of ordinary interest income into capital gain.

Since we expect the market for multiple-class mortgage pools to grow, we view seriously the potential revenue loss from continued uncertainty in this area. We thus support legislation clarifying the proper treatment of income and deductions with respect to mortgage-backed securities. We would also support, subject to appropriate safeguards, legislation that would effectively exempt the issuer of mortgage-backed securities from tax with respect to the underlying mortgages. Although we support the general direction of the legislation before this subcommittee, we remain concerned about the growth of Federal credit, including that of the Federal agencies active in the secondary mortgage market. As we have testified previously, we believe it important to encourage private issuers of mortgage securities to enter the secondary mortgage market. To this end, Treasury supports legislation along the lines of S. 1959 and S. 1978, modified, however, to prevent participation in multiple-class mortgage pools by the Federal agencies.

Mr. Chairman, let me first provide some background to my testimony. In recent years, we have seen not only substantial growth in the secondary mortgage market, but also the development of new forms of mortgage-backed securities. Although the traditional fixed investment grantor trust format, involving a single class of uniform interests, effectively has provided exemption for the issuer from tax on the underlying mortgages in a mortgage pool, it has also prevented the issuer from taking advantage of the current, positively sloped yield curve, that is, the fact that long-term yields exceed those on short-term obligations, or from offering investors any degree of call protection, that is, protection from a call triggered by prepayment of the mortgages in a pool.

Because individual mortgages are typically composed of a series of monthly payments, the cash flow from a pool of mortgages has the same temporal pattern as a series of short-term and long-term obligations. A mortgage pool may thus be used to collateralize an issue of debt obligations with differing maturities. By allocating the anticipated mortgage payments among the different classes of securities, such arrangements, commonly known as fast-pay, slow-pay, or multiple-class pools, permit the issuer to price interests in the mortgage pool along the yield curve and to offer the slow pay classes some degree of call protection. In this fashion, multiple-class mortgage pools permit an issuer to secure a better return from a secondary marketing.

Issuers were initially uncertain as to whether a multiple-class pool could be offered as a fixed investment trust and retain grantor trust status and an effective tax exemption for tax purposes. As a consequence, mortgage pool issuers have employed thinly capitalized single-purpose financing corporations to hold mortgage pools and to issue multiple classes of debt securities collateralized by the underlying mortgages. This type of debt obligation is known as a "collateralized mortgage obligation" or CMO. Nearly $27 billion of such obligations have been issued since 1983.

The CMO structure is itself relatively inefficient as a vehicle for marketing a pool of mortgages. Ideally, the corporate issuer would have no residual economic or tax consequences from its holding of the underlying mortgages, which is consistent with the intention that beneficial ownership of the mortgages be transferred to secondary investors. Although this economic result might be accomplished by leaving the issuer without significant capital and issuing obligations that in the aggregate exactly mirror the characteristics of the underlying mortgages, this would in turn threaten the issuer's status for tax purposes as the owner of the mortgages and as issuer of corporate debt.

Thus, if the issuer had no significant equity and the CMO's were designed to match exactly the cash flow from the underlying mortgages, the CMO's could be deemed to constitute equity interests in the issuer or to represent instead direct interests in the underlying mortgages. Either characterization could leave the issuer with a tax liability on the mortgage income that would more than offset any economic advantage of the multiple-class structure. To ensure that the corporate issuer will be respected as owner of the mortgages and that CMO's will be characterized as debt for tax purposes, careful issuers have attempted to satisfy minimum capitalization requirements and to retain some residual interest in the underlying mortgages. This approach introduces a degree of economic efficiency to the transaction, however, since it ties up capital in the issuer and prevents the issuer from borrowing fully against the underlying mortgages. As a consequence, some issuers have taken aggressive positions, providing little, if any, capitalization and retaining no significant residual interest in the underlying mortgages.

Since the Internal Revenue Service has not, to this date, publicly challenged the formal structure of a CMO transaction, the net effect at present is a secondary market in which conservative issuers either operate at a disadvantage or are effectively precluded from issuing mortgage-backed securities. As I have noted in my written testimony, Mr. Chairman, there are certain additional tax and nontax costs in the CMO structure.

In an attempt to avoid the business and tax costs of the CMO structure, while at the same time retaining the advantages of a multiple class format, Dean Witter and Sears in 1984 structured two grantor trusts offering investors differing temporal interests in the payment rights on $500 million pools of residential mortgages. Dean Witter and Sears managed to successfully market interests in the first pool, but in April of 1984, before interests in the second pool were sold, the IRS proposed regulations denying trust status to arrangements having multiple classes of ownership interest. Although the proposed mutliple class trust regulations have generated substantial comment, we continue to believe they were correct, as a general rule, in denying trust status to multiple class arrangements. Historically, whether an investment trust is classified as a trust or as an association has focused on whether the investors' interests were fixed or could instead be varied under the terms of the trust agreement. A power to vary the investors' interests, even though contingent in form, is sufficient to deny the arrangement trust status. Thus, the existing trust regulations limit trust classification to fixed investment trusts where there is no power under the trust agreement to vary the investors' interests.

At the time these existing regulations were promulgated in 1945, fixed investment trusts had only a single class of investment certificates. The certificates represented undivided interests in the trust property and were in form simply receipts for the securities held by the trust. Thus, where the trustee had no power to vary investment, a fixed investment trust was little more than a depository arrangement. formed to hold a specific pool of investment assets.

Although the trust device permitted individual investors to diversify their investment, the arrangement in substance provided a form of direct, if common, ownership of the trust's assets. This use of a trust to hold investment assets and thereby facilitate direct investment in a pool of such assets, is consistent with the custodial purposes that have traditionally limited trust classification. A multiple class trust investment, however, such as that formed by Dean Witter and Sears, departs from this traditional form, in that the beneficiaries' interests are not undivided but diverse.

The existence of varied beneficial interests indicates that the trust is not employed simply to hold investment assets, but serves the additional purpose of providing investors with economic and legal interests that could not be acquired through direct investment in the trust assets. Such use of investment trusts introduces the potential for complex allocations of trust income among investors, with the possibility that the timing and character of the investors' income will differ from that of the trust's.

The difficult questions that arise concerning the allocation of income to diverse classes of investors are properly foreign to the trust area, where rules have not developed to accommodate the varied forms of commercial investment and no express economic substance requirement limits the allocation of income for tax purposes.

These considerations prompted the proposed regulations issued in April of 1984, and we believe continue to require, again as a general rule, that trust status be denied to investment trusts with multiple classes of ownership.

Now, Mr. Chairman, we recognize that S. 1959 and S. 1978 are a response to the proposed multiple class trust regulations and the consequent failure of attempts to market multiple class mortgage pools in the grantor trust format. We view the legislation, however, not so much as an attempt simply to reverse the result of the proposed regulations, but instead as intended to facilitate legitimate commercial transactions while addressing the tax policy concerns that lay behind the proposed regulations. We thus support the general objectives of S. 1959 and S. 1978 and hope that this hearing begins a mutual effort to resolve the tax issues in this area. Thus, we would welcome the opportunity to work with this subcommittee, as well as with industry representatives, to develop rules which assure that income from the underlying mortgages in a multiple class pool is properly allocated and reported to investors.

To begin this process, let me offer some preliminary views on certain technical aspects of S. 1959 and S. 1978. Although the two bills would appear to have common objectives, there are potentially significant differences in their proposed treatment of multiple class mortgage pools. In general, S. 1959 allows the issuer to elect to treat the issuance of interests in a pool of mortgages as a sale of the mortgages to the investors. Investor interests in such pools are then taxed as debt obligations with new rules provided specifying the manner in which income from such obligations is to be reported. S. 1978, on the other hand, treats an issue of interests in a pool of mortgages as well as pools of various other types of debt instruments, as a grantor trust. The application of the grantor trust rules to investors, however, is not specified, leaving uncertain the manner in which income from the underlying obligations would be allocated among investors.

Although S. 1959 and S. 1978 each treat the issuer as having transferred beneficial ownership of the mortgages and thus leave the issuer free of any continuing tax liability with respect to the mortgages, we prefer the approach of S. 1959 for a number of reasons. Most importantly, we believe it is necessary that the manner in which mortgage income is allocated to investors be specified in any legislation that grants tax exemption for the issuer. Moreover, we do not believe it appropriate that the necessarily technical rules for the taxation of such income to investors be developed in the context of the rules for taxation of grantor trusts.

We also believe it is appropriate that, as provided under S. 1959, multiple class arrangements for which the issuer is granted tax exemption be limited to debt obligations in the nature of real estate mortgages or mortgage-backed securities. Although multiple class pools of auto loans, lease receivables, corporate bonds, and various other obligations may appear closely similar in concept to multiple class mortgage pools, we believe is appropriate to proceed with some caution in this area. Thus, we would wish to gain some experience with multiple class mortgage pools before seeing the extension of the concept of issuer level tax exemption to multiple class pools of other forms of debt obligations. Moreover, because of real estate mortgages' typically long-term and significant incidence of prepayment, they present the most pressing case for the allowance of multiple class arrangements.

With regard to the taxation of investors, S. 1959 amends the original issue discount provisions of the Internal Revenue Code to provide specific rules for the accrual of original issue discount on a mortgage-backed security when prepayments on the underlying obligation shorten the maturity of the interest. Current law is uncertain in this area, but we believe most taxpayers presently accrue original issue discount with respect to obligations that may be prematurely retired, based on the obligation's stated maturity, that is, based on an assumption that there will be no premature retirement. In cases where prepayments are likely, this approach bases the obligation's yield on a clearly unrealistic assumption as to its probable term, and thus results in a deferral of income for the holder as well as possible conversion of interest income to capital gain. My written testimony, Mr. Chairman, provides an example of these possible results.

Since interests in multiple class mortgage pools bear original issue discount and since the expectation of prepayments is the principal reason multiple class mortgage pools are formed, any legislation addressing the taxation of such pools must also address the effects of anticipated or actual prepayments on the proper method of accruing original issue discount. Two basic approaches to this problem exist. One is to assume, initially at least, a maturity for the debt instruments based on market expectations as to prepayments on the underlying obligations. The other approach is to assume initially that no prepayments will occur, but to provide for subsequent adjustments as prepayments actually do occur. The market expectations approach would presumably require determination of an obligation's expected maturity based in some manner on its sale price. This approach may be theoretically correct, since, if workable, it produces a taxable yield to the investor that is consistent with the probable and anticipated economic return on the obligation.

Whatever its conceptual merit, however, the market expectations approach is likely not administratively feasible. Investor expectations are not easily derived from the price paid for an interest in a mortgage pool. The price paid for such interest reflects not only prepayment assumptions but also judgments as to credit risks and future interest rates. Because the maturity and yield of an obligation are interdependent, an infinite number of prepayment assumptions may be consistent with the price paid by an investor for the interest. Moreover, although various sources compile and publish data on prepayment experience with respect to certain types of mortgages, this historical information may not accurately reflect current prepayment assumptions, and thus is not likely a valid basis on which to ground a market expectations approach.

Presumably because of the difficulty in taking account of prepayment expectations, S. 1959 takes the alternate approach to this problem of requiring adjustments to the accrual of original issue discount as prepayments occur. Under S. 1959, the accrual of OID on an investor's interest is initially based on the stated maturity of the underlying mortgages. When a prepayment on an underlying mortgage is received, thereby shortening the maturity of the investor's interest, investors accrue additional OID equal to the increase in the present value of the stream of payments resulting from the prepayment. In subsequent taxable years, the investor accrues OID on the remaining payments at the original yield. Although this adjustment approach of S. 1959 resolves the potential mischaracterization of prepayment gains that may occur under present law, it does not remove the potential for deferral of income. Thus, the rate at which OID accrues is still based initially on an assumption that payments will be received as scheduled, despite the near certainty that some mortgages in the pool will prepay.

As noted previously, one solution to the problem of deferral, assuming a maturity based on investors' expectations, is probably not feasible. Another possible approach to this problem, however, would be to impose an interest charge on the OID which is accelerated upon a prepayment. This is among the issues that Treasury would like to explore with the subcommittee and with industry representatives.

In addition to providing rules for adjusting the accrual of OID, S. 1959 also requires investors, when the entity elects to treat the issuance of interests as a sale of the underlying mortgages, to include an additional amount in income equal to the excess of the amount of income which the entity would have realized had it remained taxable on the underlying mortgages, over the aggregate amount of original issue discount accruing to the investors. This "greater of" method is intended to prevent a net loss of revenue from the creation of a multiple class mortgage pool. Without this feature, the current positively sloped yield curve would result in accrual of income on interest in a multiple class pool that is slower in the aggregate than the accrual of income to a single holder of the underlying mortgages.

Mr. Chairman, on this question of revenue I should note that Treasury is currently studying the revenue effects of S. 1959, and we will promptly apprise this subcommittee of our findings when our analysis is complete.

Let me turn just briefly to some other issues which I will not address in depth, but which must be resolved before an issuer could appropriately be exempted from tax on the mortgages in a multiple class pool. For example, S. 1959 does not address the characterization of gain upon the sale of an investor's interest. The absence of an express rule in this respect could allow an investor to defeat the proposed adjustment mechanism by selling his interest at a capital gain. In addition, we are concerned that S. 1959 fails to treat subsequent holders of multiple class interests in the same manner as subsequent holders of stripped coupons and bonds are treated under current law. Finally, significant questions remain concerning the proper treatment of contingent interests in a pool of debt obligations.

Mr. Chairman, to summarize the Treasury Department's views with regard to S. 1959 and S. 1978, let me repeat that we hope the efforts initiated by you and by Senator Cranston and others will move forward. We offer our support for these efforts and pledge to work with this subcommittee and with industry representatives to achieve a practical solution to the tax issues in this area.

Finally, Mr. Chairman, let me turn very briefly to S. 1839, which would deny a number of generally available tax benefits, such as accelerated depreciation and the investment tax credit, with respect to activities conducted in designated environmental zones. Such zones would be specified areas that are of Federal environmental concern but that are not formally part of the Federal system, such as the national park system.

Although we are sympathetic with the objectives of this legislation, we question whether it is appropriate to control private activity in environmental zones through the Tax Code rather than through direct regulation. Use of the tax laws for such purposes could involve substantial administrative complexity and would likely either discourage some activities that pose no environmental threat or result in a complex set of rules identifying activities that are appropriately exempt. Our current efforts to reform and simplify the tax system argue that we not burden the Tax Code with additional provisions designed to achieve nontax policy objectives.

Mr. Chairman, that concludes my prepared remarks. I would be pleased to answer any of your questions.

Senator CHAFEE. Thank you very much, Mr. Ross. We are delighted that the distinguished ranking member of the full committee is here. Senator Long, if you have any observation or a statement, this would be a good time.

Senator LONG. Thank you, Mr. Chairman. I have no questions at this time.

Senator CHAFEE. I just wanted to say that I am not going to get into the environmental legislation to a great degree now. You have given your views. I note in your final sentences, you say: "Our current efforts to reform and simplify the tax system argue that we not burden the Code with additional provisions designed to achieve nontax policy objectives." Let me just say that this tax reform may come out with greater fairness, but if it comes out with greater simplification, I will be amazed. Any time you are dealing with a minimum tax, as you well know, that adds incredible complexity to it.

So, let's just forget any hopes of simplification in tax reform and recognize that that is not going to take place.

Now, let me ask you about the Treasury Department's position on the Federal agency backed mortgages.

Mr. ROSS. Yes, sir.

Senator CHAFEE. If you stick by that position, how much is this new vehicle that we are talking about going to be used because you have eliminated effectively, it seems to me, the low and the moderate income mortgages. You are restricting it to the high-income housing markets, which as you know are ineligible for the backing by the Federal agencies. What is going to happen under the proposal you are making? Is this going to be a useful vehicle? If the objective is to pull down the interest rates, maybe it is only a quarter of a point, but who knows? We are denying that possibility to the people in America that we are most anxious to help.

Mr. ROSS. Mr. Chairman, I am not sure that would be the effect. Treasury's position would be that the Federal credit agencies could not themselves issue multiple-class mortgage pools. We would not, however, insist that mortgages guaranteed by the Federal agencies could not be in pools issued by private parties. Thus, I don't believe our position would prevent the benefits of this legislation from flowing through, at least indirectly, to as you say the lower and middle end of the spectrum.

Senator CHAFEE. I am not sure I agree with you. Do you consider FNMA a Federal agency?

Mr. ROSS. In effect. They have the benefit of Federal credit.

Senator CHAFEE. There is no Federal guarantee there.

Mr. ROSS. Indirectly, I believe there is.

Senator CHAFEE. Well, they deny it. All right. Should the rules that you are suggesting apply to all outstanding obligations? In other words, the ones that are out there already; or only to newly issued obligations?

Mr. ROSS. Mr. Chairman, although we haven't reached a definite view on this, I believe the rules we are proposing, at least legislatively, ought to be prospective in their effect. I don't think that precludes us from, by regulation perhaps, clearing up uncertainty under current law. But in terms of the effect of this legislation, I think we would believe it appropriate that it be prospective.

Senator CHAFEE. Getting back to the differences you are seeing between mortgages and other assets, I think the point you make is a valid one. This is a new area, so we should move a little cautiously. Certainly, in the mortgage-backed assets, we are dealing with the potentially largest pool, although I do see the excitement and the infinite possibilities that are available if we move into other areas, some of which were mentioned by Senator D'Amato. Nonetheless, agreeing with you that we ought to stick with the mortgage-backed securities to start with, do you see a difference between residential and commercial mortgages?

Mr. Ross. I do not believe so. No, Mr. Chairman. I think real estate mortgages, whether commercial or residential, are appropriately subject to this, and it is an appropriate subject for this proposed vehicle.

Senator Chafee. How would we handle adjustable rate mortgages? Does that throw additional problems into the whole equation?

Mr. Ross. They may well, Mr. Chairman. It is something that we have been studying a bit and don't have any clear answer as to how income from adjustable rate mortgages in a multiple class format would be passed through. That is one of the issues that we believe would require additional study. I could not even state a preliminary view on that. I think it is appropriate that we simply continue to look at that.

Senator Chafee. You have no thoughts on whether they should be permitted into the pool or not as of this time?

Mr. Ross. Certainly, adjustable rate mortgages have, perhaps, less so recently, but for a time were increasing as a segment of the market; and I think we would be concerned about simply excluding them. But again, I think we need to study exactly how the rules would apply in the case of adjustable rate mortgages.

Senator Chafee. What about the interests in newly created conduit entity? Should they be treated as real estate assets for purposes of real estate investment trust qualifications?

Mr. Ross. We think that is appropriate, Mr. Chairman. That is the substance of the transaction, and we have no problem with the tax law reflecting that substance.

Senator Chafee. Should they be treated as real property loans for savings and loans institutions so they can qualify for the percentage bad debt deduction?

Mr. Ross. Again, I think that is consistent with the substance of the transaction, and we would have no problem with such a characterization.

Senator Chafee. Now, I assume that if these mortgage backed securities were allowed, that interest paid on them would be exempt from the 30-percent tax on interest paid to foreigners because of the current law. Would interest on passthrough certificates be exempt under this?

Mr. Ross. I believe that is the current state of the law, yes, even where for other purposes an interest is treated as a direct interest in the underlying obligations. It is nevertheless exempt from withholding.

Senator Chafee. Do you see any problem with that exemption?

Mr. Ross. I don't. No.

Senator Chafee. All riqht. Senator Long?

Senator Long. No questions, Mr. Chairman.

Senator CHAFEE. Thank you very much, Mr. Ross. This is an area where I would like to see us do something. It seems to me there are two problems. One is how to handle the entity that is passing the interest through; and the other is the tax on the individual. It seems to me that, if Treasury can make up its mind on what it wants to do with the individual investor, and then have reporting requirements so that you can trace it, that Treasury is going to end up with more revenue than under the existing situation. Don't you think that is so?

Mr. ROSS. That would not surprise me in the least, Mr. Chairman; although our revenue analysis is still unconcluded, but that would not surprise me in the least. I would add that I agree with your thought that what is necessary here is to establish rules for taxation of the income to investors. And once that is solved satisfactorily, the characterization of the entity problem more or less disappears. I think that is the explanation for the proposed multiple class trust regulations, the inability to see in a grantor trust format how income would be allocated to investors and, thus, a necessary concern that income not simply be exempted from tax at the entity level.

But if the investor level problem is solved, then I think as you suggest the entity level issue is equally soluble.

Senator CHAFEE. It just seems to me that, from Treasury's viewpoint, if you spend a lot of time trying to differentiate what the type of income is to the investor and going into incredible complexities, which can be challenged back and forth, that the Government is going to end up with less revenue. But if you make up their minds and issue your regulations, even though you don't get every nickel in what you might capture, at least you have some certainty out there.

So, the investor can then file his reports and not be arguing with you and pay the tax.

Mr. ROSS. Mr. Chairman, I am in complete agreement. I think certainty is essential in this area because the danger, I think—and no doubt to some extent it exists under current law—is that in the face of uncertainty, you simply have noncompliance. So, I think you are right; the system would profit from greater certainty in this area.

And again, Treasury is completely supportive of your efforts and the efforts of the various industry representatives to provide that greater certainty.

Senator CHAFEE. Thank you very much. I wouldn't want you to leave thinking that we agree with everything you say about the Federal agencies—or what you call Federal agencies—not being able to participate in this. There is a little bone of contention between us; but we appreciate your help and that of Secretary Mentz. I understand Jeff Quinn helped you also.

Mr. ROSS. Very much so.

Senator CHAFEE. Thank you.

Mr. ROSS. Thank you, Mr. Chairman.

Senator CHAFEE. Now, next we will have a panel of Mr. Bernstein, Mr. Ranieri, Mr. Fink, Mr. Kasper, Mr. Horner, and Mr. Rush. If you would come forward and just sit anywhere. We will put the nameplates in front of you for your identification. Now, we will take you in the order submitted here, and we will have to be very strict about the 5-minute limitation because this is a big panel and we have others coming to testify. So, Ms. Bernstein, why don't you proceed?

[The prepared statement of Mr. Ross follows:]

For Release Upon Delivery
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STATEMENT OF
DENNIS E. ROSS
ACTING TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the Treasury Department's views on S.1959, which addresses the tax treatment of issuers and holders of interests in multiple class mortgage pools; S.1978, which addresses the tax treatment of multiple class mortgage pools as well as pools of various other debt instruments; and S.1839, which would limit the tax incentives available for investments or activities conducted in zones designated as environmentally sensitive. Let me turn first to the question of multiple class mortgage pools.

Overview

The Treasury Department shares the concern of this Subcommittee over the absence of clear rules governing the tax treatment of multiple class mortgage pools. Uncertainty under current law has effectively denied access to the secondary mortgage market for some issuers. Moreover, the existing uncertainty may result in a significant mismatch of the reported income of holders of interests in multiple class mortgage pools and the corresponding deductions of issuers, as well as the conversion for holders of ordinary interest income into capital gain. Since we expect the market for multiple class mortgage pools to grow, we view seriously the potential revenue loss from continued uncertainty in this area. We thus support legislation clarifying the proper reporting of income and deductions with respect to mortgage-backed securities. We also support, subject to appropriate safeguards, legislation that would effectively exempt the issuer of mortgage-backed securities from tax with respect to the underlying mortgages.

Although we support the general direction of the legislation before this Subcommittee, we remain concerned about the growth of Federal credit, including that of the Federal agencies active in the secondary mortgage market. As we have testified previously, we are concerned about the extent to which the Federal agencies currently predominate in the secondary mortgage market, and believe it important to encourage private issuers of mortgage securities to enter that market. To this end, Treasury supports legislation along the lines of S.1959 and S.1978, modified, however, to prevent participation in multiple class mortgage pools by the Federal agencies.

Background

In recent years, mortgage originators, such as thrift institutions and mortgage banks, have increasingly sold their mortgages to portfolio investors. This secondary mortgage market is based principally on the issuance of mortgage-backed securities, which have the advantage to investors of greater liquidity and less risk of default than individual whole mortgages.

The growth in the secondary mortgage market has also seen the development of new forms of mortgage-backed securities. Traditionally, mortgage-backed securities have been issued as certificates of undivided beneficial interest in "fixed investment trusts," which are viewed for tax purposes as "grantor trusts." In this format, the certificate holders are treated as the beneficial owners of the mortgages and bear all income taxes with respect to the mortgages.

In recent years, the issuance of a single class of uniform interests in a mortgage pool has proved to be relatively inefficient, since it prevents the issuer from taking advantage of the positively sloped yield curve (*i.e.*, the fact that long-term yields exceed those for short-term obligations) or offering investors any degree of call protection (*i.e.*, protection against a call based on prepayment of the underlying mortgages). Because individual mortgages are typically composed of a series of equal monthly payments, the cash flow from a pool of mortgages has the same temporal pattern as a series of short- and long-term obligations. A mortgage pool may thus be used to collaterize an issue of debt obligations with differing terms by allocating the anticipated mortgage payments among the different classes of securities. Such arrangements, known as "fast-pay, slow-pay" or "multiple class" pools, permit the issuer to price interests in the mortgage pool along the yield curve and to offer the slow-pay classes some degree of call protection. In this fashion, multiple class mortgage pools permit an issuer to secure a better return from a secondary marketing.

Because of uncertainty as to whether a multiple class pool could be offered as a fixed investment trust and retain grantor trust status for tax purposes, mortgage pool issuers initially turned to an alternate structure. The Federal Home Loan Mortgage Corporation ("Freddie Mac") offered the first multiple class pool in 1983 by issuing several classes of debt securities with payment schedules tied to the actual payments on a fixed pool of mortgages. Since the Freddie Mac offering, approximately $27 billion of these securities have been issued, primarily through thinly-capitalized, single purpose financing corporations. Typically this has involved creation of a subsidiary (commonly by an investment banking firm or residential construction company) solely for the purpose of holding the pool of mortgages, selling debt obligations secured by the mortgages, and transferring mortgage payments to investors in accordance with the terms of their securities.

The type of debt obligation issued by such corporations, known as a collateralized mortgage obligation ("CMO"), is itself a relatively inefficient vehicle for marketing a pool of mortgages. Ideally, the corporate issuer would have no residual economic or tax consequences from its holding of the underlying mortgages, which is consistent with the intention that beneficial ownership of the mortgages be transferred to secondary investors. Although this economic result might be accomplished by leaving the issuer without significant capital and issuing obligations that, in the aggregate, exactly mirrored the characteristics of the underlying mortgages, this would in turn threaten the issuer's status for tax purposes as the owner of the mortgages and the issuer of corporate debt. Thus, if the issuer had no significant equity and the CMOs were designed to match exactly the cash flow from the underlying mortgages, the CMOs could be deemed to constitute equity interests in the issuer or to represent instead direct interests in the underlying mortgages. Either characterization could leave the issuer with a tax liability on the mortgage income that would more than offset the economic advantages of the multiple class structure.

To insure that the corporate issuer will be respected as owner of the mortgages and that the CMOs will be characterized as debt for tax purposes, careful issuers have attempted to satisfy minimum capitalization requirements and to retain some residual interest in the underlying mortgages. This approach, however, introduces a degree of economic inefficiency to the transaction, since it ties up capital in the issuer and prevents the issuer from borrowing fully against the underlying mortgages. As a consequence, some issuers have taken aggressive positions, providing little if any capitalization and retaining no significant residual interest in the underlying mortgages. Since the Internal Revenue Service has not to this date publicly challenged the formal structure of a CMO transaction, the net effect at present is a secondary market in which conservative issuers either operate at a disadvantage or are effectively precluded.

Aside from the uncertainties as to the tax treatment of issuers, the CMO structure involves certain additional costs for holders and issuers of mortgage-backed securities. Under section 593 of the Code, a savings and loan association is entitled to claim bad debt deductions based on a special method if it holds a significant percentage of its assets in residential mortgages. Since the holder of a CMO is treated for this and other purposes as holding corporate debt rather than a direct interest in the underlying mortgages, CMOs may be a relatively unattractive investment for many savings and loans that might otherwise prefer a fast- or slow-pay mortgage pool interest.

Finally, the CMO structure is unattractive to some issuers because of balance sheet considerations. A relatively modest CMO transaction may involve over $200 million in debt securities. Although these transactions involve nearly offsetting assets and liabilities at the issuer level, many potential participants in the secondary mortgage market, including some banks and savings and loan associations, cannot, either due to regulatory or credit constraints, add significant amounts of debt to their balance sheets.

The Proposed Multiple Class Trust Regulations

In an attempt to retain the advantages of the multiple class structure while avoiding the tax and business obstacles of CMOs, Dean Witter and Sears in 1984 structured two grantor trusts offering investors differing temporal interests in the payment rights on $500 million pools of residential mortgages. Dean Witter and Sears succeeded in marketing interests in the first pool, but, in April of 1984, before interests in the second pool were sold, the Internal Revenue Service proposed regulations denying trust status to arrangements having multiple classes of ownership interests.

Although the proposed multiple class trust regulations have generated substantial comment, we continue to believe they were correct, as a general rule, in denying trust status to multiple class arrangements. Historically, whether an investment trust is classified as a trust or as an association has focused on whether the investors' interests were fixed or could instead be varied under the terms of the trust agreement. A power to vary the investors' interests, even though only contingent in form, is sufficient to deny the arrangement trust status. Thus, the existing investment trust regulations limit trust classification to "fixed investment trusts" where there is no power under the trust agreement to vary the investors' interests.

At the time these regulations were first promulgated in 1945, fixed investment trusts had only one class of investment certificates. The certificates represented undivided interests in the trust property and were, in form, receipts for the securities held by the trust. Thus, where the trustee had no power to vary the investment of the trust, a fixed investment trust was little more than a depository arrangement, formed to hold a pool of specific investment assets. Although the trust device permitted individual investors to diversify, the arrangement in substance provided a form of direct, if common ownership of the trust's assets. This use of a trust to hold investment assets and facilitate direct investment in a pool of assets by investors is consistent with the custodial purposes that have traditionally limited trust classification.

A multiple class investment trust, such as that formed by Dean Witter and Sears, departs from the traditional form of a fixed investment trust in that the beneficiaries' interests are not undivided, but diverse. The existence of varied beneficial interests indicates that the trust is not employed simply to hold investment assets, but serves the additional purpose of providing investors with economic and legal interests that could not be acquired through direct investment in the trust assets. Such use of an investment trust introduces the potential for complex allocations of trust income among investors with the possibility that the timing and character of the investor's income will differ from that of the trust's.

The difficult questions that arise concerning the allocation of income to diverse investors are properly foreign to the trust area, where rules have not developed to accommodate the varied forms of commercial investment and no express economic substance requirement limits the allocation of income for tax purposes. These considerations prompted the proposed regulations, and we believe continue to require, as a general rule, that trust status be denied to investment trusts with multiple classes of ownership.

S.1959 and S.1978

The proposed multiple class trust regulations, and the consequent failure of attempts to market multiple class mortgage pools in the grantor trust format, have no doubt prompted the legislative initiatives represented by S.1959 and S.1978. The Treasury Department supports the general objectives of the sponsors of S.1959 and S.1978, and we hope that this hearing begins a mutual effort to resolve the issues in this area. Thus, we would welcome the opportunity to work with this Subcommittee as well as industry representatives to develop rules which insure that income from the underlying mortgages in a multiple class pool is properly allocated and reported to investors. To assist in this process, we would like to offer some preliminary views on technical aspects of S.1959 and S.1978.

Overall Structure. Although S.1959 and S.1978 would appear to have common objectives, there are potentially significant differences in their proposed treatment of multiple class mortgage pools. In general, S.1959 allows the issuer to elect to treat the issuance of interests in a pool of mortgages as a sale of the mortgages to the investors. Investor interests in such pools are taxed as debt obligations and new rules are provided that specify the manner in which income from such obligations is to be reported. S.1978, on the other hand, treats the issuer of interests in a pool of mortgages as well as pools of various other types of debt instruments as a grantor trust. The application of the grantor trust rules to investors is not specified, however, leaving uncertain the manner in which income from the underlying obligations would be allocated.

Although S.1959 and S.1978 each treat the issuer as having transferred beneficial ownership of the mortgages, and thus leave the issuer free of any continuing tax liability with respect to the mortgages, we prefer the approach of S.1959 for a number of reasons. Most importantly, we believe it necessary that the manner in which mortgage income is allocated to investors be specified in any legislation granting tax exemption for the issuer. Moreover, we do not believe it appropriate that the necessarily technical rules for the taxation of investors in multiple class arrangements be developed in the context of the rules for the taxation of grantor trusts.

We also believe it is appropriate that, as under S.1959, multiple class arrangements for which the issuer is granted tax exemption be limited to debt obligations in the nature of real estate mortgages or mortgage-backed securities. Although multiple class pools of auto loans, lease receivables, corporate bonds, and various other obligations would appear closely similar in concept to multiple class mortgage pools, we believe it appropriate to proceed with some caution in this area. Thus, we believe it appropriate that we gain experience with multiple class mortgage pools before extending the concept of issuer level tax exemption to multiple class pools of other debt obligations. Moreover, because of real estate mortgages' typically long term and significant incidence of prepayment, they present the most pressing case for the allowance of multiple class arrangements.

Taxation of Investors. S.1959 amends the original issue discount provisions of the Internal Revenue Code to provide specific rules for the accrual of original issue discount on a mortgage-backed security when prepayments on the underlying obligations shorten the maturity of the interest. The existing original issue discount rules are uncertain in this area, providing only that if an intention to call an obligation prior to maturity exists at the time the obligation is issued, any gain upon redemption of the obligation (not in excess of the unamortized discount) is ordinary income. The scope of this rule is unclear, particularly as regards prepayments based on contingencies outside the control of either the issuer or holder of the obligation.

At present, we believe most taxpayers accrue original issue discount with respect to an obligation that may be prematurely retired based on the obligation's stated maturity. In cases where prepayments are likely, this approach bases the obligation's yield on an unrealistic assumption as to its probable term, and thus results in a deferral of income for the holder, as well possible conversion of interest income to capital gain. For example, assume that an investor purchases for $88 the right to receive $100 at the end of two years and that, although based on a contingency not within the control of the issuer and holder, the holder anticipates prepayment of the obligation at the end of one year. Assuming a two year maturity, $5.81 of original issue discount accrues in year one and $6.19 of original issue discount accrues in year two. If the tax treatment of the holder is based on the stated maturity of the obligation and it prepays at the end of year one, the holder will only be charged with $5.81 of total original issue discount and the excess (i.e., $6.19) will be treated as capital gain (assuming the obligation is a capital asset and it is issued by a corporation). Since the obligation's price would ordinarily reflect the anticipated prepayment, the reliance on stated term understates the obligation's expected and actual yield and results in undertaxation of the holder.

The fast-pay, slow-pay structure of a multiple class mortgage pool effectively converts obligations that ordinarily are issued without discount, i.e. the underlying mortgages, into a series of obligations that do bear original issue discount. Since the expectation of prepayments is a principal reason multiple class mortgage pools are formed, any legislation addressing the taxation of such pools should also address the effect of anticipated or actual prepayments on the proper accrual of original issue discount. At least two basic approaches to this problem exist. One is to assume initially a maturity for the debt instrument based on market expectations as to prepayments on the underlying obligations. The other approach is to assume initially that no prepayments will be made, but to provide for subsequent adjustments as prepayments actually occur.

The market expectations approach would presumably require determination of an obligation's expected maturity based in some manner on its sale price. This approach may be theoretically correct, since if workable it produces a taxable yield to the investor that is consistent with the probable and anticipated economic return on the obligation. If subsequent market fluctuations or other factors cause actual prepayments to depart from the expected pattern of prepayments, the resulting economic gains or losses are properly treated as capital items.

Whatever its conceptual merit, the market expectations approach is likely not administratively feasible. Investor expectations are not easily derived from the price paid for an interest in a mortgage pool. The price paid for such interests reflects not only prepayment assumptions, but also judgments as to credit risks and future interest rates (during the expected term). Because the maturity and yield of an obligation are interdependent, an infinite number of prepayment assumptions may be consistent with the price an investor paid for an interest. Moreover, although various sources compile and publish data on prepayment experience with respect to certain types of mortgages, this historical information may not accurately reflect current prepayment assumptions.

Presumably because of the difficulty in taking account of prepayment expectations, S.1959 takes the alternate approach of requiring adjustments to the accrual of original issue discount as prepayments occur. Under S.1959, the accrual of original issue discount on investors' interests is initially based on the stated maturity of the underlying mortgages. When a prepayment on an underlying mortgage is received, shortening the maturity of the investors' interests, investors accrue additional original issue discount equal to the increase in the present value of the stream of payments resulting from the prepayment (discounting at the original yield based on the stated maturity). In subsequent taxable years, the investor accrues original issue discount on the remaining payments at the original yield.

The following example will illustrate the application of S. 1959. Assume that investors A and B purchase interests in a mortgage pool which is composed of two mortgages. One mortgage is scheduled to pay $100 after two years and the other $100 after three years. Both investors are entitled to receive $100 but, in the event of a prepayment, A's interest will be retired first. Assume that A purchases his interest for $85.73 and that B purchases his interest for $75.13. Assume further that the payment scheduled to be received at the end of year three is in fact prepaid at the end of year one and, thus, A's interest is retired at that time; as a further result of the prepayment, B's interest will be retired no later than at the end of year two. Under S.1959, A and B would have the following tax consequences in year one. A has total original issue discount of $14.27, representing $6.86 of original issue discount which accrued in year one without regard to the prepayment, and an additional $7.41 of original issue discount attributable to the prepayment. B has total original issue discount of $15.67, which represents $7.51 of original issue discount which accrued in year one without regard to the prepayment and $8.26 of original issue discount attributable to the prepayment. A's additional original issue discount represents the unaccrued discount remaining when his interest is retired; B's additional original issue discount is the amount of discount which would have accrued in year two, but which has been accelerated because the maturity of his interest has been shortened by one year.

Although the adjustment approach resolves the potential mischaracterization of prepayment gain that may occur under present law, it does not remove the potential for deferral of income. Thus, the rate at which original issue discount accrues is still based initially on an assumption that payments will be received as scheduled, despite the near certainty that some mortgages in the pool will prepay. As noted previously, one solution to the problem of deferral, assuming a maturity based on investors' expectations, is probably not feasible. Another possible approach to this problem would be to impose an interest charge on the original issue discount which is accelerated upon a prepayment. This is among the issues Treasury would like to explore with this Subcommittee and industry representatives.

In addition to providing rules for adjusting the accrual of original issue discount, S.1959 also requires investors, when the entity elects to treat the issuance of interests as a sale of the underlying mortgages, to include an additional amount in income equal to the excess of the amount of income which the entity would have realized had it remained taxable on the underlying mortgages over the aggregate amount of original issue discount accruing to the investors. This "greater of" method (i.e. the aggregate income to investors is equal to the greater of the income accruing on their interests in the pool or the income that would accrue to a single holder of the underlying mortgages) is intended to prevent a net loss of revenue from the creation of a multiple class mortgage pool. Without this feature, the current positively sloped yield curve would result in accrual of income on interests in a multiple class pool that is slower in the aggregate than the accrual of income to a single holder of the underlying mortgages.

The following example illustrates this phenomenon. Assume a debt instrument will pay $100 at the end of year one and $100 at the end of year two. Assume the fair market value of the debt instrument as a whole is $173.55 (i.e., a 10 percent overall yield), but that the fair market value of the year one payment is $91.32 (i.e., a 9.5 percent yield) and the fair market value of the year two payment is $82.23 (i.e., a 10.28 percent yield). The original issue discount which accrues on the whole debt instrument in year one is $17.36 and in year two is $9.09. By contrast, the original issue discount which accrues on the separate components of the debt instrument is as follows: in year one, original issue discount of $17.13 (i.e., $8.68 with respect to the year one payment and $8.45 with respect to the year two payment) accrues and, in year two, original issue discount of $9.32 accrues. The example illustrates that when, as is currently true, the yield curve is positively sloped, accruing discount based on the separate yields of the various components of a debt instrument will, in the aggregate, result in slower income inclusion than accrual of discount based on the overall yield of the whole bond. The separate components ultimately accrue the same total amount of original issue discount, but a portion of it is deferred to later periods.

The "greater of" rule contained in S.1959 is a departure from the normal rules which govern the purchaser of an original issue discount obligation. The rule may well be appropriate in this context, given that S.1959 or similar legislation could dramatically expand the volume of mortgages placed in multiple class pools. Although this expansion may produce greater efficiency in the secondary mortgage market, it cannot be permitted to occur at the cost of any significant loss in revenue. In this regard, we are currently studying the revenue effects of S. 1959, and will apprise this Subcommittee when our analysis is complete.

Compliance and Other Issues. Although I will not address them in depth, a number of other issues concerning the taxation of investors must be resolved before an issuer could appropriately be exempted from tax on the mortgages in a multiple class pool. For example, S.1959 does not address the characterization of gain upon the sale of an investor's interest. The absence of an express rule in this respect could allow an investor to defeat the proposed adjustment mechanism by selling his interest at a capital gain. In addition, we are concerned that S.1959 fails to treat subsequent holders of multiple class interests in the same manner as subsequent holders of stripped coupons and bonds are treated under current law. Finally, significant questions remain concerning the proper treatment of contingent interests in a pool of debt instruments.

A final positive aspect of S.1959 is that it would repeal a variety of existing exemptions from the income reporting requirements and require that an issuer of interests in a mortgage pool report taxable income to all investors. We support this aspect of S.1959, and believe that a broad reporting requirement is an important adjunct to whatever rules are adopted for determining investors' income.

To summarize the Treasury Department's views with regard to S.1959 and S.1978, let me repeat that we hope the efforts initiated by you, Mr. Chairman, and by Senator Cranston and others will move forward. We offer our support for these efforts and pledge to work with this Subcommittee and industry representatives to achieve a practical solution to the tax issues in this area.

Environmental Zones

Let me turn briefly to S.1839, which would deny a number of generally available tax benefits with respect to activities conducted in "environmental zones." The tax benefits that would be denied include: accelerated depreciation; investment tax credit; exempt status with regard to the at-risk rules; percentage depletion; expensing of oil and gas intangible drilling costs and mining exploration and development costs; capital gains for timber, coal, and iron ore; deductions for soil and water conservation and land clearing; and the tax exemption for industrial development bonds. Environmental zones are specified areas that are of Federal environmental concern, but that are not formally part of a Federal system such as the National Park System or similar systems.

Although we are sympathetic with the objectives of this legislation, we question whether it is appropriate to control private activity in environmental zones through the tax code rather than through direct regulation. Use of the tax laws for such purposes could involve substantial administrative complexity, and would likely either discourage some activities that pose no environmental threat or result in a complex set of rules identifying activities that are appropriately exempt. Our current efforts to reform and simplify the tax system argue that we not burden the code with additional provisions designed to achieve non-tax policy objectives.

STATEMENT OF CARYL BERNSTEIN, EXECUTIVE VICE PRESIDENT, GENERAL COUNSEL AND SECRETARY, FEDERAL NATIONAL MORTGAGE ASSOCIATION, WASHINGTON, DC.

Ms. BERNSTEIN. Thank you, Mr. Chairman. Good morning, Mr. Chairman and Senator Long. My name is Caryl Bernstein.

Senator CHAFEE. I apologize for not getting this correct.

Ms. BERNSTEIN. It happens all the time, Mr. Chairman.

Senator CHAFEE. How do you spell Caryl? C-a-r-y-l?

Ms. BERNSTEIN. Yes, sir. My parents did it; I don't know why, but they did it. [Laughter.]

Mr. Chairman, I am Executive Vice President, general counsel, and Secretary of FNMA. I appreciate this opportunity to provide you with our views on S. 1959 and S. 1978. I will summarize my statement and ask that the full text be included in the record.

First, let me take a moment to explain exactly what FNMA does. Congress created FNMA to provide assistance, liquidity and stability to the home mortgage market. FNMA operates entirely in the secondary mortgage market. We purchase mortgages from housing lenders to resupply them with funds to lend people to buy homes. FNMA obtains the money to purchase mortgages largely by borrowing in the capital markets. As you said, Mr. Chairman, our obligations are not guaranteed by the United States. We also provide funding for housing by issuing mortgage-backed securities that we guarantee. Together, FNMA's portfolio and MBS finance about 1 out of every 10 mortgages in the United States.

Our innovative approaches and marketing efforts together with those of GNMA and Freddie Mac were responsible for the development and acceptance of mortgage-backed securities and other mortgage related investment vehicles that are widely used today. Freddie Mac deserves particular credit for its pioneering role in establishing the CMO, the design concept for the legislation you are considering today. As you have said, Mr. Chairman, the major impetus for legislation is the need to clarify and rationalize the tax rules governing the secondary mortgage market—an existing industry with existing mechanisms in need of sensible and neutral rules.

We applaud you, Mr. Chairman, for your timely proposal to modernize the secondary mortgage market and for holding this hearing. We are hopeful that your leadership, combined with the longstanding commitment and hard work of Senator Cranston, as well as that of Senator D'Amato, will result in specific solutions to the many Tax Code problems that curtail the flow of funds to housing. The two bills before you would simply clear away irrelevant and entangling tax rules. They use different approaches to achieve the same objective: to overcome tax impediments to the issuance of less costly mortgage-backed securities.

S. 1959 would be a major improvement in the secondary mortgage market, and we offer it our enthusiastic support. The alternative proposal, S. 1978, would also allow the issuance of multiple-class passthrough securities backed by pools of mortgages. It would provide the same treatment for various other assets as well. We encourage the melding of the two approaches and urge prompt resolution of the remaining technical problems.

The existing technical tax law impediments retard the flow of investment capital to mortgage-related investments. Any broadened investor participation in the secondary mortgage market due to this legislation would provide enhanced stability to home financing that would benefit homebuilders, lenders, and ultimately, prospective homeowners.

Significantly, each of the bills is designed to assure continued fairness among competing participants in the marketplace. Neither would preclude nor inhibit participation by any player in the market. We strongly endorse this aspect of both bills.

In modernizing the tax laws to bring about greater efficiency, Congress should not do so in a manner that advances the competitive position of a few market participants or hobbles that of others. It would be intolerable to use the proposed tax law amendments as a vehicle to change the Nation's housing policies by excluding Fannie Mae and the low to middle income segment of the home financing market that we serve from access to capital.

Mr. Chairman, the administration proposes in another context to tax Fannie Mae's portfolio operations by 50 basis points at a cost of more than $1 billion over 5 years. With the position they express today on our participation in multiclass mortgage securities, they seem intent on preventing us from doing the other significant part of our business. We have to wonder, Mr. Chairman, why they think it is in the national interest for Fannie Mae to fail.

I might also point out, Mr. Chairman, Mr. Ross' last sentence in talking about the proposed environmental amendments, the sentence that you referred to in a different context. He says: "Our current efforts to reform and simplify the tax system argue that we not burden the code with additional provisions designed to achieve nontax policy objectives." That seems to be appropriate as to the Federal agencies participation here, too.

I see that my time has run out, Mr. Chairman. Thank you.

Senator CHAFEE. Yes. As I said, we will have to be quite stern on the time limitations here. When you see the yellow light go on, you have 1 minute. Thank you very much, Ms. Bernstein. We will save our questions until each of the members of the panel has submitted his or her statement. The next witness is Mr. Ranieri.

[The prepared statement of Ms. Bernstein follows:]

Statement of

CARYL S. BERNSTEIN

EXECUTIVE VICE PRESIDENT,
GENERAL COUNSEL, AND SECRETARY
FEDERAL NATIONAL MORTGAGE ASSOCIATION

Before the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
FINANCE COMMITTEE
UNITED STATES SENATE

January 31, 1986

Mr. Chairman and Members of the Committee:

My name is Caryl S. Bernstein. I am Executive Vice President, General Counsel, and Secretary of the Federal National Mortgage Association--more commonly known as Fannie Mae. I appreciate this opportunity to provide you with our views on S. 1959 and S. 1978.

Let me summarize my statement:

- Fannie Mae supports S. 1959 as a significant improvement over current law;
- We recognize that S. 1978 would also do the job, though it is not as comprehensive as S. 1959 in addressing several significant tax concerns;
- Participation by GNMA, Fannie Mae and Freddie Mac in any legislation is critical for the low-, moderate- and middle-income housing market to enjoy its anticipated benefits;
- Nearly all CMOs that were issued in the last few years used GNMA, Fannie Mae or Freddie Mac collateral; if we are excluded, the CMO market will "dry up" almost entirely and

the proposed new multiple-class instruments will not work, thereby resulting in less money going to housing; and

- We concur with the conclusion of the Department of Housing and Urban Development (HUD), contained in a study it completed last year, that Fannie Mae's participation in any new multiple-class mortgage innovation that is approved by Congress is essential if the corporation is to continue to survive and to pursue its least risky business alternative --mortgage-backed securities.

Before discussing our position in more detail, let me take a moment to explain exactly what Fannie Mae does.

The Role of Fannie Mae in Housing Finance

Fannie Mae was created in 1938 as a subsidiary of the Reconstruction Finance Corporation to purchase mortgages insured by the just-formed Federal Housing Administration (FHA). In 1949, we also began purchasing VA mortgages. In 1954, Fannie Mae was restructured as a mixed-ownership (part government, part private) corporation to develop and support a national secondary market for residential mortgages. Fannie Mae became a wholly privately owned corporation in 1968 after we paid the government $216 million for its interest. Our stock is listed and actively traded on the New York Stock Exchange. We remain supervised in many respects by the Secretaries of Housing and Urban Development, and Treasury. Five members of Fannie Mae's eighteen-person board of directors are appointed by the President of the United States; the others are elected by our 30,000 stockholders.

Congress created Fannie Mae and charged it with one purpose: to provide assistance, liquidity and stability to the home mortgage market. The corporation operates entirely in the secondary mortgage market. We are not in any other business. We purchase mortgages from housing lenders, such as mortgage bankers, savings and loan associations, and commercial and savings banks, to resupply them with funds to lend people to buy homes and to build and rehabilitate rental properties. Fannie Mae obtains the money to purchase mortgages largely through borrowing in the capital markets.

Fannie Mae is the largest portfolio investor in mortgages, holding approximately $95 billion worth of mortgages at the end of 1985. We also issue and guarantee mortgage-backed securities (MBS), with $55 billion in MBS now outstanding. Together, Fannie Mae's portfolio and MBS finance about one out of every ten mortgages in the United States.

Fannie Mae's role as a financial intermediary enhances the efficiency of the residential finance market. Our operations transform mortgages from small, illiquid, and local investments into blue-chip corporate paper that attracts money to housing. The national scope of Fannie Mae's operations also enhances the flow of mortgage funds among geographic regions of the nation. As a major supplier of mortgage funds, we work to increase the availability of low- and moderate-income housing and to assure the quality of the home mortgage.

Our innovation and marketing efforts, together with those of GNMA and the Federal Home Loan Mortgage Corporation (popularly called Freddie Mac), were responsible for the development and acceptance of MBS and various other mortgage-related investment vehicles, including collateralized mortgage obligations (CMOs), that are widely used in the market today. Freddie Mac, in particular, should be recognized for its pioneering role in establishing the CMO--the concept upon which the legislation you are considering today is designed.

The Inefficiency of Existing Tax Rules

As you explained, Mr. Chairman, in your introductory remarks on S. 1959, a fundamental feature of any successful mortgage-backed security is that it impose the tax liability arising from mortgage payments on the investors in the security, rather than on the issuer. Under current law, pass-through investment vehicles under grantor trust arrangements and CMOs are in use. Existing tax rules governing such issuances are, however, restrictive and expensive.

Although the introduction of CMOs in 1983 allowed more active management of mortgage pools through the assignment of collateral according to investor preferences, this form of financing has certain disadvantages. Most importantly, a CMO is a debt instrument for financial accounting purposes unless it is structured very carefully to qualify as an asset sale. These tax rules were designed for other purposes and unnecessarily entangle recently developed mortgage-backed issuances.

S. 1959 and S. 1978

As you said, Mr. Chairman, when introducing S. 1959, the major impetus for this legislation is the need to clarify and rationalize the tax rules governing the secondary mortgage market--an existing industry with existing mechanisms in need of sensible and neutral rules. We agree with you that this legislation "is strictly a tax bill that does not address any credit policy issues, or differentiate among different types of securities on the basis of any credit policy concerns, and consequently debate . . . should be confined to tax policy issues."

The two bills before the Subcommittee would simply clear away irrelevant and entangling tax rules. They use different approaches to achieve the same objective--to overcome tax impediments to the issuance of less costly mortgage-backed securities.

The Secondary Market Tax Amendments of 1986 (S. 1959), proposed by Chairman Chafee, would authorize the issuance of a less encumbered CMO-like instrument. The bill would permit thrift institutions and real estate investment trusts to treat investments in the proposed collateralized mortgage securities (or CMS) as mortgage investments, provide specific (although potentially burdensome) information reporting requirements on such securities, and clarify the treatment of so-called "phantom income" affecting issuers. S. 1959 would be a major improvement in the secondary mortgage market, and we offer our enthusiastic support, subject to one important qualification only that I will discuss below.

The alternative proposal, S. 1978, would modify existing tax code provisions and rules to allow for the issuance of multiple-class pass-through securities, backed by pools of mortgages or various other assets, including consumer loans, commercial real estate mortgages, and commercial leases. While that bill is less technically complete than S. 1959, we understand that the proponents of the bills are working to resolve differences between them.

We continue to encourage that the two approaches be melded and that remaining technical problems, such as potentially burdensome reporting requirements, be resolved as soon as possible. We believe that support for these initiatives--already high in the real estate industry--would expand if one bill were put forward.

We strongly encourage you, Mr. Chairman, to take the lead in working with your colleagues to achieve this goal. You will have no stronger allies than the real estate industry if this can be done.

The existing technical impediments in the tax laws retard the flow of investment capital to mortgage-related investments; Fannie Mae, therefore, encourages Congress to pass the proposed amendments. Today's tax code provisions, and the proposed multiple-class pass-through regulations of the Internal Revenue Service, impede access to capital markets for funding. Any broadening of participation in the secondary mortgage market by new investors that could result from this legislation would provide enhanced stability to home financing to the benefit of homebuilders, lenders and ultimately to prospective homeowners.

S. 1959 and S. 1978 Are Competitively Fair.

Each bill is designed to assure continued fairness among competing participants in the marketplace. Neither the proposed collateralized mortgage securities (CMS) of S. 1959 nor the revised rules affecting grantor trusts under S. 1978 would preclude or inhibit participation by any player in the market. We strongly endorse this aspect of both bills; it is critical to uninterrupted efficiency and competition in the secondary mortgage market.

In modernizing the tax laws to effect greater efficiency in any segment of the nation's economy, Congress should not advance the competitive position of a few market participants or hobble the abilities of another. We cannot overemphasize this. It would be intolerable to use the proposed amendments that are ostensibly to improve the tax laws as a vehicle for reshaping the nation's housing policies by excluding Fannie Mae--and the low- to middle-income segment of the home financing market that we serve.

No legislation should be passed that would benefit only a few competitors in the mortgage finance market or preclude the participation of one segment of housing--particularly the low-, moderate- and middle-income housing market--from any improved financing opportunities. Mr. Chairman, we could not support the enactment of any bill unless all entities--including GNMA, Fannie Mae and Freddie Mac--are able to participate.

Finally, on a practical basis, well over ninety percent of the CMOs issued over the last few years were backed by GNMA, Freddie Mac or Fannie Mae collateral. There just is no market without the three of us, and this otherwise laudatory legislation would be relatively worthless if we are not allowed to participate. I am sure the other industry participants will agree. The only effect of excluding Fannie Mae, Freddie Mac and GNMA will be that less money will go to housing--the opposite result from what these bills are intended to accomplish.

Why It Is Critical For Fannie Mae to Participate in S. 1959 and S. 1978.

The primary objective of these bills should be to help homebuyers. If that is true, then Fannie Mae, a privately owned institution established by the Congress for the sole public purpose of facilitating credit for housing, must be included in these bills.

Congress should allow Fannie Mae to participate for several critical reasons.

- If Fannie Mae is included, these securities will benefit low-, moderate- and middle-income families because this is the market that Fannie Mae serves;
- Fannie Mae brings innovation to the mortgage market, as illustrated by our pioneering work in developing new mortgages like ARMs, 15-year mortgages, co-op loans and seconds, that make housing more affordable for American homebuyers; and
- Fannie Mae has a unique counter-cyclical role; we are in the market year-in and year-out, in good times and in bad, because the Congress chartered us exclusively to support the mortgage market.

In addition, Fannie Mae's ability to compete fairly with other issuers in the capital markets is critical to the financial recovery of the corporation. We instituted a self-help financial recovery strategy four years ago to repair our mismatch of assets and liabilities--a strategy to help housing while helping ourselves. Its key elements are:

- purchasing higher-yielding and shorter-term assets to offset the losses on the existing low-yielding, fixed-rate portfolio;
- launching a mortgage-backed securities program to enable us to continue to support the mortgage market in a less risky manner; and
- lengthening the maturity of the debt we raise to finance our portfolio purchases.

The success of our efforts was proven in 1985. We made modest profits, while at the same time we dramatically improved the mismatch between our assets and liabilities, reducing our estimated duration gap from 2.6 years at the end of 1984 to 1.6 years at the end of 1985. For the first time, our MBS product accounted for more than half of our total business. Since this is the least risky form of business in which we can engage, both we and the Congress should want to expand our MBS issuances. These bills would help us do that.

Any new mortgage investment vehicle would be important to our financial recovery in two ways. First, our MBS program could continue to compete in the marketplace and benefit the hundreds of thousands of families we serve every year if we are included in such legislation. Last year, our $45 billion in purchases and securities issued served 900,000 families. Second, if CMS are used, as some have advocated, as a way to help thrift institutions restructure their mismatched portfolios, Fannie Mae could use them in exactly the same way. This would be a big boost to our self-help strategy, enabling Fannie Mae to get back on its feet financially more quickly.

Both our portfolio role in bringing affordable mortgage instruments to the low-, moderate- and middle-income housing market and the future success of our MBS program argue strongly for Fannie Mae's inclusion in the proposed legislation.

HUD Study Shows That Fannie Mae Must Participate to Survive.

In 1983, legislation was introduced to authorize an entirely new mortgage-related investment vehicle, popularly known as TIMs. The technical imperfections of the Trust for Investment in Mortgages (TIMs) proposal could presumably have been resolved; however, that legislation was doomed by the efforts of the Administration to preclude any role for federally sponsored credit agencies, including Fannie Mae and Freddie Mac.

An analysis of the proposed TIMs concept, completed by HUD in 1984, concluded that prohibiting Fannie Mae from participating in TIMs or similar multiple-class mortgage securities would be self-defeating. A prohibition would expand Fannie Mae's potential losses and deny it an opportunity to "drift away from its federally guaranteed risk-taking portfolio investment." That HUD study, entitled "Impact of TIMs on FNMA," carefully analyzed the balance among three policy goals inherent in the question of Fannie Mae's participation in mortgage-related investment vehicles: increasing credit market efficiency, reducing the federal role in housing finance, and reducing federal exposure to a theoretical failure of Fannie Mae.

We do not agree with every statement in the HUD paper. That HUD analysis was particularly on point, however, in its conclusion that the continued viability of the corporation is wholly dependent upon our ability to participate in the development of any new mortgage-related securities products.

The HUD study estimated the present value of lost fee income to Fannie Mae from prohibiting our MBS from collateralizing TIMs (or mutiple-class mortgage securities) to run as high as $1 billion. We would forego additional income by not issuing or servicing TIMs securities. In short, our future MBS income stream would be drastically curtailed.

HUD recognized in that report that Fannie Mae MBS involve relatively slight risk. More significantly, HUD noted that the competitive strength of Fannie Mae, Freddie Mac and GNMA MBS does not arise from any federal subsidy to the housing sector relative to other capital uses. Rather, it is a result of the "truly lower cost of securitization and assurance of credit-worthiness" in MBS. (See page 22).

The HUD study rejected the argument, sometimes advanced to justify the exclusion of Fannie Mae, that such a restriction would reduce the contingent liability of the federal government. The study found that view "incorrect." Moreover, it observed that "In fact the opposite outcome is more likely." If Fannie Mae could not participate in TIMs, HUD believed that would hasten a financial crisis at Fannie Mae by limiting the demand for our MBS and seriously limit our ability to reduce interest rate risk and to survive.

The Subcommittee should consider this legislation in the same context. As the HUD study recognized, Fannie Mae must participate in any newly designed multiple-class mortgage securities to continue to reduce its risk and the contingent liability to the government. If we cannot be competitive in the MBS business, we would have to shift back to greater portfolio investment to survive, and no one wants that. HUD noted that "In fact, the ability to issue TIMs [or similar multiple-class mortgage securities] could expedite the packaging and sale of 'underwater' loans" by Fannie Mae. (See page 21).

Attachment I is a copy of the HUD study for the record.

Conclusion

We support S. 1959 as a substantial improvement over current law, but only so long as all existing secondary market competitors can participate. The three entities entirely dedicated to housing--GNMA, Fannie Mae and Freddie Mac--must be allowed to participate fully.

This legislation, and particularly Fannie Mae's inclusion in its provisions, is supported by all major housing groups and the investment banking community. Indeed, many of them have said, and we wholeheartedly agree, that the legislation would be useless without our participation. The only result of our exclusion would be less money for housing--the opposite of what S. 1959 and S. 1978 are intended to do. HUD also found in a recent study that it is important to our financial success and to the government's exposure to risk that we be included in this kind of legislation.

Mr. Chairman, I very much appreciate this opportunity to testify on the proposed bills. I look forward to working on this legislation with you and with all others interested in an America in which we can make it affordable for everyone who wants to buy his or her own home to do so.

THE IMPACT OF TIMs ON FNMA

The Federal National Mortgage Association (FNMA) is currently a major policy concern because of its large presence in the mortgage market and its precarious net worth. FNMA, like the thrift industry, takes risks from interest rate changes when it purchases fixed-rate mortgages (FRMs) for its portfolio while issuing short-term debt. The unanticipated rise in interest rates since 1979 has pushed the portfolio into a negative net worth of about $7 billion on an $80 billion portfolio. The large loss on the portfolio could become a Federal liability, because the links between FNMA and the Government have fostered the view that FNMA debt is Federally-guaranteed.

While FNMA is continuing to bear risks from interest rate changes, its position is being further eroded by competition from other sources. Not only is the thrift industry better able to compete after deregulation as it gains access to market-rate credit, but also the secondary mortgage market, led by the rise in mortgage-backed securities (MBSs), is providing increasing competition. These securities are being used in innovative ways that provide direct competition to FNMA. For instance, Collateralized Mortgage Obligations (CMOs) have packaged MBSs in ways that could compete with FNMA in its traditional role as portfolio investor, leading to a squeeze on its profits. They do this by dividing the pools into different classes which pay off principal at different rates, allowing investors to better choose the maturity of their share in the pool.

Attachment I

Trusts for Investment in Mortgages (TIMs) are also a major policy concern, because they are another potentially important innovation in marketing mortgages. As is discussed below, they allow investors in mortgages to sell off or hedge against some unwanted characteristics of mortgages by repackaging mortgage pools in ways similar to the CMO but with additional registration and tax advantages. By doing this, they broaden the market for mortgages, increase competition, and lower mortgage rates. TIMs and FNMA are related concerns because, while TIMs will help mortgage borrowers, they will almost certainly reduce FNMA profits if FNMA is not permitted to participate in them. This presents a problem because of the connection of FNMA with the Government, and because the losses FNMA already has on its portfolio make it difficult to remove these Federal connections.[1] To the degree that FNMA's net worth problem is not resolved it will be difficult to reduce the Federal role in credit markets and ultimately to move toward total privatization of FNMA.

This paper takes the perspective that TIMs or a similar multiple-class mortgage security are becoming an important part of the mortgage market whether or not Federally-sponsored agencies participate. Moreover, FNMA's role in the TIMs market must be viewed in the context of an overall resolution of FNMA's problems. The introduction of TIMs would expand FNMA's potential losses as a risk-taking portfolio investor, just as CMOs have, but it would also expand the demand for their MBSs, as well as give them the opportunity to earn income from TIM-related financial services. Thus, TIMs would encourage FNMA to drift away from its Federally-guaranteed, risk-taking portfolio investment. However, prohibition of FNMA participation in the TIMs market, on the grounds of restricting the Federal role in credit markets, would eliminate its potential gains.

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[1] See for example, Senator Garn's letter to Secretary Regan published in U.S. Congress Hearings before the Senate Committee on Finance, "Trust for Investment in Mortgages Proposal and Tax Treatment of Secondary Market," Nov. 4, 1983, p. 225.

The purpose of this paper is to analyze and estimate the gains and losses to FNMA from the use of TIMs in order to assist in the balancing of three potentially conflicting policy goals, increasing credit market efficiency, reducing the Federal role, and reducing Federal exposure to a failure of FNMA. The paper begins with a discussion of FNMA's net worth problem. Section II then analyzes the role the perceived Federal guarantee on FNMA debt plays in motivating FNMA to engage in interest-rate risky portfolio investment. Section III discussess the relatively new development in housing finance of multiple-class mortgage securities, e.g., CMOs and TIMs. Section IV estimates the direct impacts of multiple-class securities on FNMA's long-run profitability. Section V explores the effects of restrictions on FNMA's participation in the market for multiple-class mortgage securities, in general, and TIMs, in particular. The final section discusses the relation between privatizing FNMA and restricting its participation in TIMs or similar securities.

I. FNMA'S NET WORTH PROBLEM

Throughout the 1970s FNMA played the role of a portfolio investor by raising short-term funds in the capital markets and purchasing long-term fixed-rate mortgages. In the highly regulated and interest-rate-ceiling-constrained financial environment that preceded the financial reforms of

1980 and 1982, interest-rate volatility was low. Therefore, this type of investment behavior, which takes advantage of the normally upward-sloping yield curve, was also very profitable.

By 1980 the economic environment in which FNMA operated had changed dramatically. Interest rates increased sharply, reaching unprecedented levels in 1980 and 1981. FNMA's average borrowing costs, even with Federal backing, increased from 10.72 percent in 1979, to 13.37 percent in 1980, and to 16.22 percent in 1981. Because of the mismatch in the corporation's assets and liabilities, the gradual increase that also occurred in the net yield on the mortgage porfolio could not keep pace with the sharply increasing cost of funds. As a result, FNMA's profitability fell off sharply.

The change in economic environment did more than just reduce FNMA's profitability. The increased interest rate volatility also increased the risks associated with borrowing short and lending long, and the deregulated financial enviorment has provided the housing industry with other means to tap the capital markets. Thus, while a reduction in interest rates would solve a good deal of FNMA's current problem, such a reduction in rates would not eliminate the risks to FNMA's purchasing of fixed-rate mortgages for portfolio.

One way of understanding FNMA's position is to estimate the "mark to market" value of its assets minus liabilities. This represents the net loss if FNMA were liquidated. This requires first estimating the market value of its mortgages, which requires estimates of how rapidly old mortgages have prepaid and then pricing the remaining balances. Our conservative estimate is that as of mid 1984 FNMA's mortgage portfolio would sell off at less than 85 percent of par for a nearly $14 billion loss on its $83 billion portfolio.

FNMA also has some cash and the "mark to market" value of its debt is almost about 4 percent less than par, leaving "mark to market" net worth of roughly minus $7 billion.

II. FNMA'S FEDERALLY-GUARANTEED RISK-TAKING

Given FNMA's enormously negative economic net worth, one might wonder why it continues to exist and to have stock outstanding which has a value of on the order of $1 billion. Private institutions can survive with some negative net worth and have their stock selling at a positive price if there is a chance that they will improve in the future. But at some point that chance becomes too remote for creditors to continue lending to the firm, in which case the firm cannot meet its oblilgations, and it then shuts down.

There is no doubt that a fully private firm with FNMA's balance sheet would not be able to borrow and would be shut down. What then keeps FNMA going? The answer is the perceived Federal guarantee of its debt. As long as the public views FNMA as risk-free, it can borrow -- even to pay off salaries and dividends. Hence, the mechanism that would operate in the private sector, a creditor revolt, is not operative for FNMA.

From the stockholder's perspective, this enhances the value of the stock. If FNMA could borrow to pay dividends, it would have some short-run value. But more to the point, FNMA has some long-run value even if it does not pay dividends. This is because there is always a chance that it will improve. For instance, interest rates could fall, just as they rose, and raise the value of FNMA's "underwater" mortgages. Note that FNMA stock has a value not because interest rates are expected to fall but simply because they might fall. The bettors, i.e. the stockholders, have -- because of limited liability -- limited losses; their stock can be no worse than of zero value. If things go the wrong way, FNMA may indeed default; that is, it may have such a big deficit that the efficacy of its guarantee becomes undermined and it is forced to shut down. Nevertheless, the loss of the stockholders is limited to their initial investment.

The point, with respect to FNMA's current situation, is that it has little to lose and much to gain by incurring interest rate risk. The more risk it takes the greater the chance that it will rise from the ashes. There is no mechanism for creditors to get FNMA to worry about the "downside" risks. FNMA is betting with Federal money and little of its own.

It is easy enough to understand that, given a large negative net worth, FNMA has little to lose with a "go for broke" strategy, but it is also the case that even if started anew, FNMA would still have incentives to take risk, by borrowing short and lending long. Again, the reason is that stockholder losses are limited without there being a mechanism for creditors to impose discipline. The incentive is weaker, if the stockholders will have some positive net worth in their portfolios to lose, i.e., they are betting with some of their own money. Thus, we might not expect a complete "go for broke" strategy, but rather simply more risk-taking than a private firm would take.

Note, however, that a "go for broke from the start" strategy is not without precedent. It is apparently the strategy followed recently by Financial Corporation of American (FCA), which bought an enormous amount of fixed-rate mortgages with short-term debt, in the hope that interest rates would decline. FCA did not need to expect interest rates to decline. It was only necessary that there be a chance of a decline, because the "downside" risk was "covered" by the Federal Savings and Loan Insurance Corporation (FSLIC).

The value of FNMA's guarantee cannot be directly measured, but we can use the above information to infer how the market values the guarantee. We do this by noting that the value of all of FNMA's assets must equal the value of all of its liabilities plus the value of its equity. Its assets include not only its financial assets, mainly mortgages, but also the Federal guarantee. Hence as a matter of arithmetic the market value of its guarantee equals its negative financial net worth, which we estimate to be roughly $7 billion in mid 1984 plus the value of its stock, which is approximately $1 billion. Hence, the value that the market is putting on the guarantee to FNMA is approximately $8 billion.

III. MULTIPLE-CLASS MORTGAGE SECURITIES (MCMS)

While FNMA has been experiencing the benefits and costs of being a Federally-guaranteed, risk-taking portfolio investor, there has been a revolution in mortgage finance. In the last decade market forces and financial deregulation eroded the walls between the housing finance system and the general capital markets. Today, there is an enormous secondary mortgage market in which mortgages can be sold to many potential investors, and as a result mortgages are evaluated by the market according to the same standards as other securities. The market interest rate to homebuyers reflects the risk premiums required by the ultimate investor plus the costs of channeling the funds from the investor to the borrower.

The major channel for mortgage funds from the capital markets is the mortgage-backed security (MBS). The basic MBS is a pool of mortgages, at least $1 million dollars in size, in which shares are sold off to investors, accompanied by a guarantee of timely payment on the loans so that investors do not need to evaluate the credit risk of the loans themselves. The investor essentially receives a fixed portion of the pool's payments, including principal payments and prepayments of entire loans, as well as interest payments. The timing of the repayments of principal is uncertain, depending on the sales or refinancing of the homes. However, if the mortgages are fixed-rate mortgages, the refinancings are not random. Rather they are systematically related to the course of interest rates. If rates fall, many borrowers choose to refinance (which is usually relatively inexpensive). If rates increase, borrowers attempt to avoid prepayment as much as possible.

This systematic bias toward an undesirable prepayment pattern is called prepayment risk. The borrower's ability to freely prepay a mortgage makes the maturity of a standard pool of mortgages uncertain, and it lowers the average yield on the pool. This uncertainty makes mortgages in the standard MBS pool less attractive to investors like pension funds with long-term liabilities.

Both Trusts for Investments in Mortgages (TIMs) and Collateralized Mortgage Obligations (CMOs) are devices that address prepayment risk. The basic TIM or CMO divides a pool of mortgages into several parts. The first part (or tranche) receives all of the principal payments until it is paid off; then the second tranche receives principal until it is paid off, etc. The last tranche has shed much of the risk of prepayment. Hence, a pension fund might well want to buy the "slow pay," or last tranche of a TIM, while a thrift looking for a short-term asset might want to hold a "fast-pay" tranche.

An MBS with such a multiple-class structure is called a Multiple-Class Mortgage Security (MCMS). The main impediment to accomplishing this multiple-class structure through a traditional MBS is a tax one. Put simply, an issuer of a mutiple-class MBS could be treated as if it were setting up a corporation, with holders of shares in the MBS pool taxed twice: at the "corporate" level and at the shareholder level as dividends. Clearly that would make such a structure prohibitive.

Ordinary MBS pools haved avoided this problem by being set up as "Grantor Trusts." Grantor Trusts are devices that can avoid double taxation; but they were set up before MBS pools were important, and they are not flexible enough to satisfy the needs of potential MCMS investors. They avoid the double taxation, but they do so by requiring that the management of the pool be totally "passive." Ordinary pools are, indeed, passively managed, doing little more than passing through mortgage payments. However, the allocation of principal payments to different classes of shareholders in the typical type of MBS arrangement, which involves legal sale of the mortgage pool, apparently violates Grantor Trust tax provisions.[2]

In the absence of specific legislation on TIMs, the private market has found a way of avoiding double taxation, and that is to do an MCMS as debt. That is what a CMO is. In a CMO, a pool of mortgages is used to collateralize a debt of the issuer. The debt is issued with different classes. Since interest payments on debt are deductible, the return on the pool is not taxed twice.

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[2] Preliminary IRS regulations published in May 1984 declared MCMSs which were legally sales of assets to not be eligible for Grantor Trust Treatment. Final regulations have not been published.

Creating an MCMS as debt (a CMO) rather than an asset sale (a TIM) is appealing to thrifts who can use them to "sell off" old mortgages without having to record losses, which could affect their ability to maintain the net worth requirements of FSLIC. However, treating CMOs as debt has been viewed as an impediment to mortgage bankers because of the high debt-to-equity ratio that CMOs as debt might imply.[3] In addition, there are significantly greater procedural costs in setting up a CMO. Perhaps most importantly, because CMOs are debt their purchase by thrifts does not qualify for the tax incentive contained in Section 593 of the Internal Revenue Code, dealing with the thrifts bad debt allowance. Hence, even though CMOs have done much of what was originally envisioned in TIMs (i.e., provide call protection), for many investors and issuers, a TIM would be a more efficient instrument.

The market success of CMOs strongly confirms the usefulness of the multiple-class approach to dividing up mortgage cash flows. The first CMO was issued by the Federal Home Loan Mortgage Corporation (FHLMC) in June of 1983 and was collateralized by conventional fixed-rate mortgages. FHLMC has done (as of October 31st) four issues with about $3 billion in mortgages and is planning a fifth of $500 million. Almost $10 billion of other CMOs have been done by private issuers, of which $6.1 billion were collateralized with

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[3] The Financial Accounting Standards Board has recently produced a technical bulletin on the CMO issue. The study seems to have satisfied mortgage bankers by viewing CMOs of the sort done so far (where issuers take on negligible residual risk) as asset sales for accounting (not tax) purposes, so that CMOs are not added to their balance sheet as debt.

Government National Mortgage Association MBSs (GNMAs), $271 million were collateralized by unsecuritized conventional loans, and the rest were collateralized by combinations of conventional and FHA mortgages and FNMA, FHLMC, and GNMA mortgage-backed securities. Pension funds have purchased the bulk of the slow-pay tranches, while thrifts and banks have favored the fast-pay ones.

A TIM would be at least as useful in promoting efficiency in the market for housing finance as a CMO. Moreover, the propriety of changing the tax treatment of a TIM is generally agreed upon. Instead, the principal issue raised by TIM legislation is the future role of Federally-sponsored credit agencies in the mortgage market. Their participation could prevent the use of TIMs put together by totally private firms, since the agencies have a cost advantage in the MBS market. The general question of agency participation is discussed later. However, the current financial weakness of FNMA forces consideration of the question from the point of view of minimizing potential liabilities of the Government. That issue is explored in the next section.

IV. EFFECTS OF MCMSs ON FNMA PORTFOLIO INVESTMENT

While we do not have any experience with TIMs we do have a good deal of recent experience with CMOs, which we shall use as a benchmark. CMOs affect FNMA because they compete with FNMA's portfolio purchases from both the asset and liability sides of the market. In the markets for raising capital, CMOs may have already made it a little more expensive for FNMA to borrow, since the middle tranches of the CMOs have characteristics like that of medium-term FNMA debt. For example, many commercial banks view medium-term CMO debt as similar to medium-term FNMA debt. A precise calculation of the effects of CMOs on FNMA's cost of funds is difficult to make because we have not had enough experience to estimate it properly. But even if the effect is small, it can have a significant impact on FNMA's profits over time.

Even if it is difficult to make any judgments about the quantitative effects of a TIM-like instrument such as a CMO on FNMA's borrowing costs, it is clear that these instruments will reduce FNMA's profitability to the extent that they succeed in reducing mortgage yields. The current evidence is that the effect of CMOs on mortgage yields is substantial. The most immediate evidence is that spreads between GNMA MBSs (pools of FHA-insured mortgages) and Treasury debt have fallen rapidly since the introduction of CMOs. In the month before the first CMO (May 1983), the spread between GNMA 13s and 10-year Treasuries averaged 215 basis points; by June 1984, it was only 88 basis points. Similar comparisons using FHLMC PCs and Federal Home Loan Bank Board (FHLBB) mortgage rates reveal similar trends.

It is difficult to infer exactly how much of this drop was actually due to CMOs, because other things, such as changes in yield curves, were also happening at the same timne. We do note that: (1) the timing of the decline coincided closely with the growth in the GNMA-CMO market in late 1983 and early 1984, (2) we have not previously seen a change in spread that was so fast over so short a time, and (3) conversations with people active in the market indicate a strong belief that CMOs did lower GNMA yields. Hence, while we are still uncertain as to the exact magnitude of effects of CMOs on fixed-rate mortgage rates and of how long their effects will last, there is evidence to support the range of public estimates of from 10 to 15 basis points to more than 50 basis points.[4] Moreover, the issuance of TIMs instead of CMOs could reduce mortgage rates further, because holdings of TIMs would be eligible for the Section 593 bad-debt allowance for thrifts.

Even under the most conservative estimates that: (1) TIMs would reduce mortgage yields by an average of only 10 basis points (on all types of mortgages), and (2) they increase FNMA's borrowing costs by 5 basis points, the net change in spread can be important, due to FNMA's enormous size. At this time, FNMA's portfolio is about $80 billion, most of which is in fixed-rate mortgages which will be replaced in the next 10 years. A mere 15 basis points combined increase in borrowing cost and decrease in mortgage return would, if FNMA's portfolio remained constant, reduce FNMA's profitability on new mortgages by over $120 million per year. This exceeds FNMA's net income ($75 million) for 1983 by more than 50 percent. The present value of this never ending loss (discounted at a conservative rate of 14 percent) is over $850 million. ($120 million/.14).

Should FNMA's portfolio grow, the future loss will be even greater (assuming that most of the growth is in fixed-rate loans). For instance, if we assume a growth rate of 7 percent per year, then we must discount the income at 7 percent (the 14 percent rate less the 7 percent rate of growth). In this case, the present value of FNMA's loss is approximately $1.7 billion ($120 million/.07). If the growth rate is 10 percent, which is much closer to FNMA's rate of the past four years, the loss is $3.0 billion ($120 million/.04).[5] Less conservative assumptions with respect to the impact of TIMs on FNMA's spread would double or triple these estimates of reduced profitability.

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[4] The lower estimate was given by a Professor George Kaufman at a HUD conference in March 1984; the latter estimate was made by a number of experts at the Senate Finance Committee Hearings cited earlier.

The implication is that increased competition from TIMs or even just CMOs does not bode well for FNMA in the longer term. But FNMA does have some alternative activities open to it. It can purchase more adjustable rate mortgages (ARMs). The impact of TIMs on the return on ARMs should be much less, since prepayment risk is lower on them already. However, the market rates on ARMs are currently viewed as being at or below the long-run return needed to cover costs and earn an appropriate risk-adjusted return. Alternatively, FNMA may attempt to expand its volume of regular MBSs (not used in TIMs or CMOs). But competition with MCMSs would make them less profitable. MBSs are also preferable to the Federal Government, because they do not add significantly to FNMA's risk burden. In fact, FNMA is presumably already doing as much of each activity as it can profitably, since it currently faces no limit to those activities. Thus, FNMA probably cannot turn to these options to recoup much of its losses from TIMs.

In addition, there are two new options opened up by the creation of TIMs. FNMA MBSs are desirable for creating either a TIM or a CMO. To the extent that these instruments expand the demand for securitized mortgages, FNMA could find the demand for its MBSs significantly increased by providing services related to creation of a TIM. We next evaluate these potential sources of compensating benefits to FNMA of TIMs, in the context of considering the option of restricting FNMA participation in the market for TIMs.

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[5] All of these figures are for the present value of the reduction in profitability, once FNMA's existing portfolio of mortgages and borrowings completely turns over. If we assume that the portfolio turnover rates will average 10 years, then the present discounted values of these losses in 10 years are approximately $210 million, $850 billion and $1.0 billion, respectively.

V. EFFECTS OF POTENTIAL RESTRICTIONS ON FNMA

If there is a TIMs Bill which replaces CMOs with an asset-sale type of multiple-class mortgage security, a decision will also have to be made on the role of FNMA in TIMs. One option is both to allow it to issue TIMs and to allow its MBSs to collateralize someone else's TIMs. However, the absence of restrictions on FNMA and other Federally-sponsored credit agencies would make an expansion in the secondary mortgage market of the totally-private sector more difficult. Thus, two basic restrictions on FNMA's participation in a TIMs market have been proposed:

(1) Forbid FNMA MBSs to be used in private sector TIMs; and/or

(2) Forbid FNMA itself from issuing TIMs.

Policy options include adopting one or both or neither of these restrictions. In this section, we consider the effects of each of these restrictions on FNMA profits. In doing so we make the assumption that FNMA's participation in the CMO market is indicative of its potential role in TIMs.

Restriction 1: Do Not Permit FNMA MBSs to Collateralize TIMs or CMOs

FNMA would benefit from the use of its MBSs in the creation of TIMs, just as they have been used in some CMOs. The use of FNMA's MBS in TIMs would expand the demand for its MBS. Because of its ability to sell a government guarantee, FNMA's MBS is a product for which FNMA has a competitive advantage and on which it earns profits. Even if FNMA does not actually issue a TIM, not permitting FNMA MBSs to collateralize TIMs or CMOs would reduce its profits. We next estimate the potential profits to FNMA that would be foregone due to a restriction on the use of their MBS in TIMs (and thus in any MCMS). We build on the evidence available from the current MBS and CMO markets.

In the year and a quarter since FHLMC sold the first CMO (in June 1983), some $13 billion in CMOs have been sold. Private investment bankers have predicted that more than $25 billion more will be sold in the next two years.[6] Clearly this is a large market, and a source of potential revenue for FNMA. Its MBSs are just beginning to be used as collateral for CMOs, with about $1 billion used so far. Estimating the impact on FNMA of being kept out of the TIMs business by using CMO experience is difficult for at least three reasons. First, the CMO market is very new, and it is difficult to forecast its long-run size. Second, the size of the TIMs market may be very dependent on precisely what restrictions are placed on involvement by Federally-sponsored agencies. Third, the role of FNMA's MBS in the CMO market is just beginning. While CMOs have been issued since June of 1983, they have been collateralized with FNMA MBSs only since the beginning of 1984. We make some simple projections of the size of the CMO market and the size of FNMA's share, which will yield some "order of magnitude" estimates of the potential income to FNMA from providing MBSs to a market for TIMs.

FNMA MBSs collateralized about $1 billion in CMOs in the year since the first CMO issue. FNMA earns 25 basis points per year on its MBSs, so that this $1 billion in CMOs generates about $2.5 million per year in fee income.

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[6] Salomon Brothers, Senate Finance Hearings, op cit. p. 175.

FNMA MBSs collateralized about $1 billion in CMOs in the year since the first CMO issue. FNMA earns 25 basis points per year on its MBSs, so that this $1 billion in CMOs generates about $2.5 million per year in fee income. The present value of this stream (if we assume it to be perpetual) at current mortgage rates of about 14 percent is about $18 million (2.5 million/.14). However, FNMA MBSs were late-comers in backing CMOs (the $1 billion is only about 9 percent of the first year market). If we assume that FNMA's share will be the same as its recent share of the entire MBS market, about 20 percent, then the present value of the CMO business for one year more than doubles, to about $40 million.

This estimate assumes that the dollar value of the MBS market stays constant. But the mortgage market and its securitized portion have grown rapidly. For example, mortgage-backed securities made up less than 1 percent of the mortgage market in 1970; by 1983 they accounted for 23 percent. The growth rate in securitization implied by this shift exceeds 40 percent per year. Furthermore, the size of the mortgage market will continue to grow as well, certainly with inflation, if for no other reason. If we assume a conservative growth rate of CMO-MBS activity of 10 percent, then we must discount the above figures at 4 percent (the 14 percent interest rate minus the 10 percent growth rate). For the 20 percent market share (which generated $40 million in present value every year) we have a high estimate of $1 billion ($40 million/.04) as the present value of the lost fee income.

We should note that FNMA's estimate of the lost fee income is as large as $100 million per year by 1985-86. This would imply the issuance of over $40 billion in FNMA MBSs for use in TIMs. Moreover, the $100 million is almost twice the size of all of FNMA's fee income in 1983. It is based on some rather optimistic assumptions and is almost certainly too high. But there is some room for differences in projections and our assumed growth rate is conservative compared to recent experience.

Both the $1 billion in present value or the $100 million per year may be overestimates of the effect on FNMA profits. Some of the 25 basis point fee must cover default, delinquency and other costs. If we use the GNMA experience with these kinds of costs, at least 15 to 20 percent of the fee earnings would have had off-setting expenses, and our cost estimate should be correspondingly reduced. Also, FNMA is taking on some default risk that GNMA does not take.[7]

These estimates assume that the TIMs market is at least as large as the CMO market. However, if GNMA and FHLMC are also prohibited from issuing or collateralizing TIMs and CMOs, the demand for TIMs will be reduced (almost all CMOs so far have used FNMA, GNMA, or FHLMC MBSs), and this will limit both the negative effect on FNMA portfolio earnings and the positive effect on their MBS market. The size of the effect will depend on the importance to investors of the FNMA, GNMA, or FHLMC guarantee and the ability to find a substitute for that guarantee (e.g., by using private insurance and/or FHA/VA loans). If TIMs do succeed in the absence of any agency involvement, then FNMA would suffer a loss in portfolio earnings with no benefit from additional MBS issuances. In fact, FNMA MBS issuance could decline from current levels to the extent that private MBSs gain a greater share of the market.

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[7] GNMA loans all have FHA/VA insurance covering 100 percent of the loan, where as the conventional loans in FNMA pools all have 20 percent down-payments or private insurance on only the top portion of the loans.

Restriction 2: Prohibit FNMA from Issuing TIMs

Issuing a TIM can be thought of as two acts: issuing an MBS and then carving the MBS into different tranches. We have just estimated the value to FNMA of the first act: issuing an MBS which someone else can carve up into a TIM (or CMO). We now address the benefits of allowing FNMA to perform the second act: carving up the MBS.

Apparently, issuing CMOs has not been valuable so far because FNMA has not issued any CMOs. It has instead issued its own, non-callable debt to support its portfolio purchases and produced MBSs, which others have carved into CMOs. That is not surprising because, as we have just argued, FNMA has an advantage in selling a Federal guarantee and not in packaging TIMs or CMOs. The market for packaging CMOs is already very competitive, and it may be that FNMA cannot do the packaging as cheaply as current CMO-issuers. Rather it need only sell the FNMA guarantee and let someone else sell the individual packages. Then FNMA will only want to issue TIMs if it can gain some advantage in comparison with issuing CMOs.

TIMs differ from CMOs primarily by the fact that they involve the sale of the mortgage assets rather than the issuance of debt against them. This would give FNMA another route to participate in the mortgage market without issuing more debt. It could earn some fee income from issuing TIMs. In addition, FNMA's use of its own MBSs in issuing TIMs would assure a role for the FNMA MBS in the market for multiple-class mortgage securities and provide a ready conduit for disposing of loans from their portfolio.

However, it is difficult to judge how much additional income FNMA could earn from this activity. There is currently no market in TIM-issuance services, and it is likely that whatever market arises will be extremely competitive. In any case, FNMA may find it profitable to provide ancillary financial services to TIMs in addition to issuing its own TIMs.

FNMA has estimated the potential revenue alone from issuing TIMs and providing these services at $50 million annually for 1985-1986. We have no way of confirming that estimate nor did FNMA provide an estimate of the income net of expenses.

No Restrictions

The presence of no restrictions on FNMA would permit them to earn fee income both from providing MBSs for use in TIMs and from managing TIMs portfolios. The present value of the net income from these fees may not exceed $1 billion, but they should partially or even fully offset the lower spreads FNMA will receive on portfolio investing.

VI. PRIVATIZATION OF FNMA

Our estimates of the present value of lost fee income to FNMA from a prohibition on MBS collateralization of TIMs run as high as $1.0 billion. Additional income could be foregone from a restriction on issuing or servicing TIMs. Meanwhile, TIMs or even the current CMOs will reduce the spread on future portfolio activities. Because of these considerations, the TIMs issue must be put into the context of the FNMA's net worth problem.

FNMA's portfolio of FRMs shows a substantial loss at this time, and they are seeking additional sources of income to balance those losses. However, the most attractive source of income is additional purchases of

FRMs, which increase the risk of even bigger losses in the future. Unrestricted participation in TIMs would compensate by providing FNMA with stronger markets for its MBS and other services and allow a shift away from portfolio investing. In fact, the ability to issue TIMs could expedite the packaging and sale of "underwater" loans.

Because the restriction of agency involvement in TIMs has also been the focus of Congressional Hearings,[8] it is worth considering the reasons for this restriction. The Hearings made it clear that the chief rationale for the restriction was to encourage private competition to the Federally-sponsored agencies. However, the cost of this encouragement may be reduced efficiency in the provision of mortgage-backed securities. In a recent analysis, Professor Edward Kane indicates[9] that the chief cost of restricting Federally-sponsored issuance of MBSs would be a reduced efficiency in resource allocation. TIMs collateralized with agency loans do lower mortgage rates, by lowering the costs of undertaking financial transactions, saving real resources. Essentially, Federally-sponsored agencies face lower costs of conveying to investors the validity of the guarantees associated with MBSs. Yet agency collateralization exposes the Government to very little extra default risk, and to almost no interest rate risk. Furthermore, since restrictions on agency collaterization of TIMs would apply only to conforming (i.e., smaller) loans, the cost of restrictions is borne by middle- to lower-income households. Permitting a costly market imperfection for these households seems to be an undesirable way to encourage the private sector.

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[8] Senate Finance Committee, Nov. 1983, op cit.

[9] Forthcoming, Housing Finance Review.

Along with promoting the private provision of secondary market services, there are two other reasons for restricting FNMA from involvement with TIMs. One is that the availability of implicit or explicit Federal guarantees for MBSs through GNMA, FNMA, and FHLMC constitutes a subsidy to the housing sector relative to other capital uses. This is the other side of the argument favoring greater private activity. However, there is no evidence that inappropriate charges are being made for the relatively slight risks involved in the MBS programs. As noted above, competitive advantage of the Federally-sponsored agencies arises instead from truly lower costs of securitization and assurance of credit-worthiness, not from a subsidy.

A second major rationale for imposing restrictions on FNMA participation in TIMs seems to be the belief that the restriction would reduce the contingent liability of the Federal Government. Such a view is incorrect. In fact the opposite outcome is more likely. The reason for FNMA's current problems, and the major source of its potential cost to the Government is the interest rate risk it takes on by borrowing short and lending long. But, the MBS program involves no interest-rate risk. By limiting the demand for the MBS program through restrictions on FNMA's collateralizing TIMs, we would limit FNMA's ability to avoid interest rate risk and still survive. Such a limitation on Federal credit, in effect, may trade a possibly beneficial form of Federal intervention, i.e., FNMA MBSs, for a particularly pernicious one, FNMA's interest rate risk. In addition, it could hasten a financial crisis at FNMA. Thus, rather than viewing a FNMA-collateralized TIM as a further expansion of Federal involvement in the credit markets, it should be seen as a device that can allow for the ultimate privatization of FNMA, if that were the goal, by alleviating FNMA's net worth problem and reducing its Federally guaranteed, interest-rate risk-taking portfolio investments.

STATEMENT OF LEWIS S. RANIERI, MANAGING DIRECTOR, SALOMON BROS., INC., NEW YORK, NY, ACCOMPANIED BY REBECCA WALKER, PRESIDENT, RESIDENTIAL FUNDING CORP., MINNEAPOLIS, MN

Mr. **Ranieri.** Mr. Chairman and Senator Long, my name is Lewis Ranieri. I am a managing director and member of the executive committee of Salomon Bros., and I am accompanied today by Rebecca Walker, president of Residential Funding Corp., a subsidiary of Salomon Bros.

Salomon Bros. has been a pioneering firm in the development of the mortgage-backed securities area over the last 15 years. In addition, we are proud of the fact that we were the first firm to have underwritten an issue of securities, known as CARS, backed by auto receivables.

We wish, Mr. Chairman, to commend you for introducing legislation to clarify and modernize the tax treatment of mortgage related securities. We also wish to commend Senator Cranston for his efforts with respect to securities backed by other assets. The focus of Senate bill 1959 is the secondary mortgage market, and I would like to direct the focus of my comments to that market.

The secondary mortgage market, as you know, is now the major source of funding for fixed-rate mortgages, provides the major alternative to the floating rate market, and has consistently done that since its inception in the mid-1970's. I think the viability of that market is no longer in question and its effectiveness in bringing down the cost of housing to the consumer is well demonstrated.

In 1983 I, testified before the Senate Banking Committee in support of enabling legislation to employ a technology, which a number of us here were instrumental in creating, to further bring down the cost of housing. This technology was called the multiple-class security. I testified that I thought that the technology would significantly bring down the cost of housing, by more than 50 basis points, as an example, as well as be a potent force in terms of maintaining the availability of long-term fixed-rate money.

I think both of those statements were justified by the market over the last 2 years. There are in excess of $30 billion worth of these securities that were issued in those 2 years, and I think most people would assert that they have been very effective in lowering the cost of housing.

The reason we are here testifying on Senate bill 1959 is that, although the new technology works, it cannot currently be implemented in its most effective way. So, it certainly has lowered the cost of housing but not as much as all of us would like. We need to correct some of the inadvertent tax problems that arise in employing the technology for its most forceful use. In addition, I might add, many of us are in fact concerned that in some way the technology is inadvertently being perverted as a result of certain tax problems. Let me explain. The most effective use of the technology currently is achieved by issuing a bond. Now there are very few entities who are sufficiently well capitalized, with large balance sheets, to be able to afford to issue these bonds, while the great majority of issuers in the market cannot issue bonds. As a result, a few large issuers, including Salomon Brothers, frankly have been able to have an advantaged position in this market versus the market as a whole. As a result, unfortunately, a great deal of these bonds have not resulted in a pure passthrough of rate savings to homeowners, but have, in fact, been arbitrage bonds.

You might ask: Why does Salomon Brothers, one of those people who are advantaged, want to see it changed? The answer is that no privileged group can exist for very long, and it is in our best interest not to alienate the housing market as a whole, the consumers as a whole, for some short-term advantage we may get because of inadvertent tax problems.

I also wish to add that even if this debt restriction were to be circumvented, we would still have major problems in terms of reporting income for both individuals and corporations; and I think that should be a concern to Treasury and the tax-writing committees, because of the confusion it is creating in the market.

In our view, we strongly support S. 1959. We strongly support the intent of 1978, as introduced by Mr. Cranston. We would all love to have all assets———

I would like to raise one remaining issue in my remaining time; and that is the Federal credit issue, raised by Treasury: and the exclusion of the agencies. I do not believe that that frankly is appropriate to deal with when dealing with tax matters. That is a policy issue which I think is best handled in other areas of the Congress.

And in my remaining time, I would like to have Rebecca Walker, with your permission, to come up and comment. She is in fact the private sector that tbe Treasury is saying they would like to prefer.

Senator CHAFEE. That is a rough distribution of time you have done, Mr. Ranieri. [Laughter.]

You took 4¾ minutes and gave Ms. Walker a quarter of a minute. We will do it, Ms. Walker. I suppose he is your boss—is he? [Laughter.]

Go to it, in 15 seconds or less.

Ms. WALKER. OK. In the past, I know that questions have been raised whether———

Senator CHAFEE. So that we won't be deemed sexist here, you may go to it for a couple of minutes.

Ms. WALKER. Thank you. Thank you very much. I know that questions have been raised about new vehicles designed to improve the efficiency of the secondary mortgage market and whether they should be available for securities issued or backed by the Government-chartered secondary market agencies, Fannie Mae or Freddie Mac. Our own industry, the private secondary mortgage market, has opposed expansion of the operations of these Government competitors in a number of different areas.

Nevertheless, we believe that the issue of the proper role of these Government-chartered agencies is not germane to the legislation at hand. The issue under review is how to tax multiple-class transactions, not how to use the Tax Code to accomplish extraneous nontax economic or social policies. In fact, we believe that if we were able to issue multiple-class passthrough securities, we might be able to compete more effectively with these Government-chartered secondary market agencies.

Regardless of one's views on Federal credit policy, it makes no sense to us to have one set of tax rules for privately backed securities based on sound tax principles and another set for Government-issued or Government-backed securities based on faulty or ill-conceived tax principles.

Thank you very much.

Senator CHAFEE. Thank you, and I think Mr. Ranieri should buy you lunch.

Ms. WALKER. He will.

Mr. RANIERI. I generally do. [Laughter.]

Senator CHAFEE. All right. Mr. Fink?

[The prepared statement of Mr. Ranieri follows:]

Statement Of Lewis S. Ranieri
Managing Director
Salomon Brothers Inc.
New York, New York

Before The
Senate Finance Subcommittee On
Taxation And Debt Management
On The Subject Of S. 1959 And S. 1978

January 31, 1986

Introduction

Mr. Chairman and Members of the Subcommittee on Taxation and Debt Management, my name is Lewis S. Ranieri, and I am a Managing Director of Salomon Brothers Inc. I am also a member of the Executive Committee of Salomon Brothers. I am accompanied today by Rebecca Walker, President of Residential Funding Corporation of Minneapolis, Minnesota. Residential Funding Corporation, a subsidiary of Salomon Brothers, is a private sector, mortgage conduit similar in function to the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

My principal responsibility at Salomon Brothers is the direction of our firm's Mortgage Department which encompasses all of our activities in the underwriting, issuing and trading of mortgage-related securities and securities backed by other financial assets. Salomon Brothers has been a pioneering firm in the development of mortgage backed securities over the last 15 years. In addition, we are proud to have been the first firm to have underwritten an issue of securities, known as CARS, backed by automobile loans. That security was issued in December of 1984.

I appreciate this opportunity to testify before the Subcommittee this morning in support of S. 1959 and in support of the goals of S. 1978. Both bills would permit the issuance of multiple-class mortgage-related securities in pass-through form. S. 1959, in addition, would clarify how the OID rules of current law apply to multiple-class debt securities and require expanded information reporting on multiple class securities. S. 1978 would authorize multiple class pass-through securities backed by non-mortgage assets.

We wish to highly commend you, Mr. Chairman, for introducing legislation to clarify and modernize the tax treatment of mortgage-related securities. We also wish to commend Senator Cranston for introducing S. 1978, which has as its goal the authorization of multiple class pass-through securities backed by non-mortgage assets.

As Chairman Chafee indicated in his floor statement, the major impetus for this legislation is the need to clarify and rationalize the tax rules governing a large and important segment of the capital markets. There is an existing industry with existing financing mechanisms that are in need of sensible and neutral tax rules that reflect the true economic substance of the transactions involved. The focus of Senator Chafee's bill is the secondary mortgage market and I would like to direct the focus of my comments to that market. However, I would like to state for the record our view that clarification of the tax rules for multiple class securities will provide substantial benefits of capital market efficiency and reduced interest rates regardless of the nature of the underlying assets.

The Importance Of The Secondary Mortgage Market

It is not an exaggeration to suggest that a virtual revolution has occurred in the last 15 years with respect to the financing of residential mortgages in this country. In recent years, patterns of great volatility in interest rates have led to periodic periods of disintermediation and resulting mortgage credit shortages. A few years ago, there was a real question whether large numbers of American homebuyers would continue to have the option of a reasonably priced long-term fixed-rate home mortgage. Competition for deposits and the deregulation of the Federal depository system have made it more difficult for thrift institutions, the traditional sources of mortgage money, to continue to provide a steady source of long-term fixed-rates mortgages.

Although adjustable rate mortgages can reduce the risk of fluctuating interest rates for banks and savings and loan associations, adjustable rate mortgages shift the risk of volatile interest rates to American homebuyers.

It would, of course, be wonderful if we could return to the simple financial world of a generation ago, when mortgage lenders accepted passbook savings deposits at 3%, lent out long-term mortgage money at 6%, and no one worried about oil shocks, inflation, or budget deficits driving interest rates sky high. Returning to a more stable interest rate environment would be desirable. But that is unfortunately not something any of us can count on. The reality we must face is that neither the majority of the nation's depository institutions, nor the typical American homebuyer, are eager to accept the risk of rapidly changing mortgage interest rates.

The mortgage finance industry would still be on the horns of this dilemma as to who should bear this "interest rate risk" associated with long-term borrowing, were it not for the fact that there are lenders and investors who are willing, and indeed eager, to lend money at fixed interest rates for long periods. Increasingly, the logical source of capital for long-term mortgage money are the nation's pension funds, insurance companies, banks, foundations, and other institutional investors who are looking for fixed rate, medium-term and long-term investments.

It has always been unwieldy for large institutional investors to invest in individual mortgage loans. However, by packaging large numbers of individual mortgage loans into mortgage pools, and issuing securities backed by those loans, secondary mortgage market participants like Salomon Brothers have succeeded in creating an efficient and attractive way for the capital markets to provide mortgage money to the American homebuying public.

It is difficult to overstate the increasing importance to the American homebuyer of what we call "securitization" -- the process of turning pools of home mortgages into securities, that can be sold to capital market investors. The percentage of home mortgage loans that are being securitized has grown from only 1 or 2 percent of loan originations in 1970, to almost 40 percent in 1985. Lest there be any misunderstanding, it is important to remember that in many cases it is only the ability to securitize and sell a mortgage to investors in the secondary market that enables a neighborhood mortgage lender to make an individual loan commitment at a reasonable interest rate.

Mortgage securitization, in short, is performing a critical business function in bringing together long term fixed rate investors and mortgage borrowers. Because of its success in providing a better match of the needs of lenders and borrowers, the secondary mortgage market has experienced phenomenal growth over the last 15 years. In 1970, there were less than $1 billion of outstanding publicly-issued mortgage backed securities. By the end of 1985, there were almost $400 billion of such securities outstanding, a market almost as large as the $472 billion of outstanding publicly-issued corporate bonds.

Although securitization is important for new mortgage loans, it is also important as a financial liquidity tool for thrift institutions with large portfolios of older loans. Thrift institutions and other portfolio lenders can profitably utilize mortgage backed securities to borrow against their existing portfolio of older fixed-rate mortgages. This source of funds can facilitate their origination of new fixed or adjustable rate mortgages, or diversification into other forms of lending.

Innovations In The Secondary Mortgage Market

The secondary mortgage market may be the most innovative and rapidly changing financial market in the world. Slightly over two years ago, I appeared before the Senate Finance Committee to testify in favor of legislation which was intended to solve what was then thought by some to be a problem that was insurmountable without Federal tax legislation. The objective was to find a way to allow security issuers to divide up a pool of long-term mortgages into short-term and long-term securities -- based on the recognition that a given percentage of the loans in the pool were likely to prepay as homeowners moved or refinanced and paid off their mortgages. Despite the fact that this legislative initiative did not succeed, the secondary mortgage market quickly succeeded itself in developing a vehicle, known as the collaterized mortgage obligation or "CMO", which accomplished under existing tax law many of the financial goals that were once thought to be impossible.

The CMO is a bond, usually issued by a corporation, structured with both short and longer term investments that are retired out of the proceeds of a pool of mortgage loans. The CMO structure assumes (on the basis of sound statistical research) that some thirty-year mortgages will actually be paid off in, say, 2 to 5 years; others will be paid of in, say, 5 to 10 years; and still others will last a full 30 years. In somewhat oversimplified terms, the CMO structure, in effect, assigns the shorter term mortgages to short term investors (providing them with a true, short-term investment), and, in effect, assigns the medium-term mortgages to medium-term investors. Finally, the long-term investors get the "call protection" of a true long-term investment by being assigned the cash flow from the mortgages that will last a full 30 years. This innovative CMO structure has already been credited with substantially reducing mortgage interest costs.

The Need For Legislation

Although over $30 billion of CMO's have been issued since the first public issue in June of 1983, there are still a series of tax and accounting problems facing issuers and investors in these securities, as well as potentially serious tax compliance and tax administration problems which should be of concern to the Treasury Department and the tax writing committees.

The CMO is a perfectly legitimate financial instrument under existing tax laws. However, current tax regulations do not permit a similar investment to be structured with multiple classes of ownership interests in a pool of mortgages. If such a multiple class pass-through instrument were authorized, mortgage bankers, commercial banks, or other institutions could sell ownership interests in mortgages to security holders. In the CMO format, in contrast, the institution must retain ownership of the mortgages and issue bonds secured by the mortgages.

There are several advantages to selling mortgages instead of issuing mortgage backed bonds:

- Selling mortgages, means that added debt does not need to be carried on an institution's balance sheet. Balance sheet concerns now effectively preclude many mortgage bankers, thrifts, and other financial institutions from participating in the CMO market to any significant extent.

- In a CMO issue that is classified as debt for tax purposes, the issuer may be required to retain an "equity" interest in the mortgages. In other words, the issuer cannot fully borrow against the value of the mortgages, and must retain a residual interest in the mortgages. With less cash received up front, the CMO is less useful as a financial liquidity device for thrifts seeking to restructure their portfolios. This equity requirement also imposes additional legal, accounting and capital costs on the issuer. In part, this is attributable to the fact that current law is unclear as to precisely how much "equity" is required, and indeed whether any equity at all is required. These transaction costs reduce the financial advantages of the CMO.

- Asset sales may provide greater security to the investors and thus reduce interest costs by reducing credit risks attributable solely to the formal retention of ownership of the underlying collateral by the issuer.

Investments in CMOs do not technically qualify as mortgage investments. This is of concern to thrifts and other entities that are required by various tax rules to invest in mortgages.

- Finally, the technical tax rules for CMOs are uncertain and may impose taxes on an issuer despite the fact that it has not truly received any economic gain. This "phantom income" problem of "income without gain" can be quite serious where the collateral is seasoned mortgages that bear less than current market interest rates.

S. 1959

Senator Chafee's bill would address all of these problems of existing law with four major provisions:

- The bill clarifies the precise method of computing original issue discount on CMOs, in a manner that reduces inappropriate "phantom income" taxable to issuers and ensures that investors are properly taxed.

- The bill permits CMO-like investment arrangements to be structured as ownership interests in a passive, multiple class entity (referred to as a collateralized mortgage security or CMS) with strict rules designed to ensure that the amount, timing, and character of income realized by the investors is not reduced, slowed down, or otherwise modified so as to be adverse to the revenues.

- The bill provides that investments in the newly authorized CMS are treated as investments in mortgages under the tax code. This would enable thrift institutions and real estate investment trusts to invest in the new instrument and retain the tax advantages of investing in mortgages.

- The bill provides for expanded information reporting on mortgage related securities. This would improve taxpayer compliance and eliminate the potential for a "whipsaw" effect disadvantaging the Treasury when issuers and investors take inconsistent tax reporting positions.

In our view, S. 1959, by addressing these significant tax and accounting problems, will increase the efficiency of the secondary mortgage market, reduce mortgage interest rates, and improve taxpayer compliance. We strongly support the bill and respectfully urge its expeditious enactment.

S. 1978

S. 1978, introduced by Senator Cranston, raises the important question whether new rules to clarify and modernize the tax treatment of multiple class securities should be extended to all asset backed securities. We are not aware of any fundamental difference between mortgage backed securities and other asset backed securities and would strongly support Senator Cranston's goal of expanding the scope of tax legislation adopted by the Committee to other asset backed securities.

Federal Credit Issue

Finally, I would like to address an issue which I believe is unrelated to the tax issues raised by S. 1959 and S. 1978, but which in the past has been linked to the issues addressed by these bills. Both the Administration, and Members of the Congress, have from time to time expressed concerns about the role of the Federally chartered secondary market agencies -- FNMA, FHLMC, and GNMA -- in the secondary mortgage market. It is quite appropriate for the Administration and the Congress to raise these concerns and to deal with issues of Federal credit policy through review of the powers and activities of these agencies.

We believe, however, that it would be a serious mistake to link those issues, which are periodically reviewed in the Senate and House Banking Committees, to the resolution of the tax issues addressed by S. 1959 and S. 1978. Although we support passage of S. 1959 because it would improve the efficiency of secondary mortgage market transactions, it is unlikely the efficiency gains would outweigh the benefits of the implicit or explicit Federal credit support which would be associated with the participation of these secondary market agencies. As a result, a multiple-class pass-through vehicle which could not be used with agency-backed mortgages would, for the most part, simply not be utilized. Thus, the Administration's possible goal of creating a dual market with a competitive disadvantage for agency backed securities would in substance, not be furthered. Moreover, precisely because the agencies have such a dominant role today in the market, merely clarifying and modernizing the tax rules for multiple class securities (which are currently being issued at a rate of more than $1 billion per month) could not, in our view, significantly increase the agencies' role in the market.

Finally, without enacting comprehensive tax legislation for all multiple class mortgage backed securities, the Congress may lose an important opportunity to address the tax administration and tax compliance problems that may arise if the industry continues to innovate and expand without guidance as to the proper tax rules to apply to these transactions.

Conclusion

That completes my testimony, and I would be happy to respond to any questions the Subcommittee may have.

STATEMENT OF LAURENCE D. FINK, MANAGING DIRECTOR, FIRST BOSTON CORP., NEW YORK, NY

Mr. FINK. Thank you, Mr. Chairman and Senator Long. I will summarize my statement this morning, and I would like to also add a few other comments in regard to the Treasury's position.

My name is Laurence Fink. I am a managing director of the First Boston Corp. in New York. I am in charge of the mortgage products group, the national products group at First Boston, and also I am a member of the management committee of the firm. First Boston has been very instrumental in the growth of the secondary mortgage market. In 1985, we were the number one issuer in CMO's, and in 1985, we were the number one issuer in all asset-backed securities. To date, for one automotive company, we have securitized $925 million of auto financed paper, and this morning we will be announcing another $100 million financing for another auto finance company. We have also been responsible for securitizing computer leases, and we have securitized some private placements, blocks of $100 million and larger sizes for bank holding companies of automobile finance paoer.

The big position that we would like to stress this morning is how we could differentiate the securitization of multiclass pass throughs for one asset, be it a real estate receivable, versus other assets—automobile paper, computer leases, credit cards. With the technology that we have today, it is very difficult for me to determine that we cannot create proper mechanisms and safeguards for real estate and mortgages, and we cannot create those safeguards for automobile paper and other types of receivables.

What we prescribe is a level playing field for all assets. Receivables are very similar. They pay monthly. They amortize principal. They look the same. They are just simple cash-flows owed from one person paid to another. Security interests for receivables should not be a reason for making distinctions. Also, it is a very good policy for the United States and for its consumers. We have other needs other than housing, and securitizing and creating a multiclass bill for all assets would achieve in bringing down interest rates for all assets, not just for mortgage assets.

We, at First Boston, believe that both bills are an appropriate step in the right direction; but we strongly urge the action taken by the subcommittee should apply to all assets. In addition, I would like to make a number of comments regarding the Treasury's position.

The agencies have been instrumental in creating this growth in the secondary mortgage market. It is inconceivable for me to believe, without the role of the agencies with new added powers, the secondary mortgage market will enhance as readily as it has in the last 15 years. In addition, the role of the agencies has provided a benchmark for other issuers to look upon and to take and carry forward the growth in this marketplace. We need the agencies as a benchmark, and we need the agencies for further strength in the mortgage market. In addition, the Treasury mentioned that they have some questions regarding the understanding of other assets. They mentioned they do not have any questions regarding the securitization of commercial real estate. The securitization of commercial real estate will become a gigantic market; there is no one questioning that. It has already begun.

But the understanding of these assets is nc different than the understanding of automobile assets; and that distinction does not make too much sense in our minds at First Boston.

I want to again thank the subcommittee for allowing us to have this opportunity. And once again, I would like to urge the subcommittee to look at both positions and allow the securitization for a multiclass bill and for all assets.

Thank you.

Senator CHAFEE. Thank you very much, Mr. Fink.

Mr. Kasper?

[The prepared statement of Mr. Fink follows:]

TESTIMONY
OF
LAURENCE D. FINK
MANAGING DIRECTOR

THE FIRST BOSTON CORPORATION
NEW YORK, NEW YORK

BEFORE THE
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT
OF THE
COMMITTEE ON FINANCE
OF THE
UNITED STATES SENATE

ON
THE TAX TREATMENT OF
MORTGAGE AND ASSET BACKED
SECURITIES

January 31, 1986

Mr. Chairman and other members of the Subcommittee,

My name is Laurence D. Fink and I am a Managing Director of The First Boston Corporation. I am in charge of our Mortgage Products Group and our Asset Finance Team. First Boston is a leading international investment bank which, together with its affiliate, Credit Suisse First Boston, underwrote more securities in 1985 than any other investment bank in the world. The First Boston Mortgage Products Group is responsible for servicing the investment banking needs of the thrift and mortgage finance industry. In this capacity, First Boston is involved in numerous activities, including trading and sales, underwriting, financial advisory services, stock issuances, thrift conversions, mergers and acquisitions and dealing in all mortgage related securities. Under various measures of determining underwriting share used by the securities industry, First Boston was either the first or second largest underwriter of mortgage securities in 1985. Our Asset Finance Team is a multidisciplined group of professionals whose mandate is to develop financing methods which permit industrial and service corporations, banks, thrifts, government agencies and finance companies to securitize all types of non-mortgage receivables in order to realize the cost benefits associated with access to the capital markets. I am proud to say that First Boston was the leading underwriter of Asset Backed Securities in 1985 and has been the lead underwriter of over 84% of the Asset Backed Securities publicly offered to date. It is from this perspective that I address you today and I thank you for this opportunity to do so.

INTRODUCTION

The Subcommittee has before it two bills, S. 1959, the "Secondary Market Tax Amendments," sponsored by Senator Chafee and S. 1978, the "Recovery Act for Mortgage and other Asset-Backed Securities," sponsored by Senators Cranston, D'Amato, Dixon, Dodd, Mattingly and Riegle. As a general matter, both bills have as their purpose amending the tax code to remove certain unintended impediments to the ability of American businesses and consumers to meet their funding needs in the most cost efficient manner. I strongly support the efforts of the sponsors of these bills and commend the members of this Subcommittee for addressing these issues in a year which promises to place heavy demands on the members of the Committee on Finance.

The cornerstone of both bills is the authorization of a multiclass pass-through security as a means of facilitating the securitization of home mortgages and other credit instruments. The Collateralized Mortgage Security that would be created by S. 1959 and the Multi-Class Pass Through Security that would be authorized by S. 1978 would each permit a more efficient means of funding than is permitted by current tax law. Simply stated, a multiclass security generally is more efficient than a single class security because it increases the ability of issuers to provide investors with a security that exactly meets their individual requirements. This results in greater proceeds for the issuer. Present tax law causes issuers wishing to realize these benefits to issue multiclass securities, such as Collateralized Mortgage Obligations, in the form of new debt obligations or borrowings. This, in turn, means that issuers that want to make use of a multiclass security must be willing to carry increasingly large amounts of debt on their balance sheets. Under current tax law, issuers can avoid this unwanted expansion of the balance sheet only by foregoing the benefits of the multiclass security. S. 1978 would remedy this by authorizing the Multi-Class Pass Through Security which is a multi-class security that allows for a sale of receivables. The Multi-Class Pass Through Security would allow issuers to target their securities to the specific requirements of various investors without inflating their balance sheets. S. 1978 would make this benefit available to private issuers as well as to federally sponsored agencies and quasi-agencies such as the Government National Mortgage Association ("GNMA") the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC"). I strongly endorse S. 1978 and the authorization of the Multi-Class Pass Through Security for all issuers.

As introduced, S. 1959 would remove the unintended impediments of the tax code only for certain types of receivables, those secured by an interest in real estate. Receivables secured by an interest in personal property or unsecured receivables would continue to be funded by methods that are needlessly inefficient and complicated. S. 1978 would not create such a distinction without a difference. S. 1978 would allow the most efficient security to be used for all types of receivables. As the Subcommittee works to fashion a remedy in this area, I strongly urge you to support the approach taken by S. 1978 and to provide a solution that is as broad as the problem.

Finally, S. 1959 addresses legislatively certain technical aspects of the tax code as it relates to the multiclass mortgage securities that would be authorized by that bill. I commend Senate Chafee's undertaking to grapple with this extremely complicated area of taxation. S. 1978 would have these technical clarifications of the tax code addressed by regulatory action. However this Subcommittee decides to address this problem I offer First Boston's commitment to work with the Subcommittee and its staff, Treasury and others to clarify the application of certain tax code provisions to existing as well as proposed mortgage and Asset Backed Securities.

The Need for A Multi-Class Pass Through Security

As a first step, it is important to understand securitization, the funding needs of the various public and private sectors and the investment requirements of the capital markets. Generally speaking, securitization in the context of mortgage and Asset Backed Securities is the process by which cash flows resulting from pools of mortgages or other receivables owned by one or more entities are identified, analyzed and otherwise modified for resale in order to more closely meet the investment requirements of various sectors of the capital markets. Securitization is the process of reconciling the often-time contradictory payment demands of consumers and the cash flow demands of investors. On the one hand, consumers demand terms on their obligations that meet their particular income and budget needs. On the other hand, investors, like most people, will pay the highest price for the product that exactly meets their needs. The goal of securitization is obvious if not simple: take the cash flows generated by a pool of consumer receivables and tailor them to best fit the individual requirements of various investors. By way of illustration, consider this simple example. Borrower would like to buy a new car and would like to finance that purchase with a four-year loan. Auto Finance Company will lend Borrower the funds needed at an interest rate that will depend in turn on Auto Finance Company's own cost of borrowing, or, alternatively, on the price Auto Finance Company would receive if it could sell Borrower's loan to investors. Investor A would like to purchase the only first year of Borrower's loan. Investor B, on the other hand, would be happy to purchase the second, third and fourth years of the loan. If either Investor A or Investor B has to buy a part of the loan that does not meet his needs, he will pay a lower price--if he is still willing to purchase at all. The ideal solution to Auto Finance Company's funding needs is obvious: sell Investor A the first year of Borrower's loan and sell Investor B the remainder. Current tax law, however, does not allow Auto Finance Company to do the logical thing. It cannot sell Investor A the first year of the loan and Investor B the remainder without incurring an additional level of tax that destroys the economics of the transaction. That result leaves Auto Finance Company with two less desirable choices. Auto Finance Company can either sell Investors A and B something that neither truly wants in exchange for a lower price, or, alternatively, keep the loan in its own portfolio and increase its own borrowings, knowing that such additional borrowings likely will increase the interest rate and maturity mismatch of Auto Finance Company's assets and liabilities, adversely affect its debt to equity ratio, and generally detract from its ability to borrow. All of which means that the American consumer will have to pay more interest than an efficient market otherwise requires. Obviously, my example is a simple one. In real life, there would be many more borrowers and many more investors, each with his respective interests and requirements. In addition, in many instances the lender, Auto Finance Company in my example, will also be interested in retaining a specific part of the loan for its own investment requirements.

Theoretically at least, there are several ways to eliminate or at least reduce the inefficiencies imposed on the securitization process by current tax law. First, it is possible that investors could change their pricing evaluation methods; however, this seems unlikely. The high interest rates of the late 1970s and early 1980s taught us all the hard lesson that borrowing short and lending long, or more generally, a lack of asset-liability matching can produce devastating results. Second, it is possible that changes in the receivable origination process could prove effective to limit this inefficiency; however, this also seems unlikely. Assuming for the moment that there were no practical or state law problems with originating receivables that exactly matched the requirements of the capital markets, with certain limited exceptions, current tax law would impose an additional level of taxation on any "arrangement" that provides for more than one class of interest in an asset. Again, the imposition of such a tax would in most instances destroy the economic gains of more closely matching receivable cash flows to investor requirements. Indeed, it is the uncertainty of the imposition and the nature of such a tax that deters the use of any securitization method that even remotely could be construed as being a multiclass arrangement.

Existing Market Practice

The Collateralized Mortgage Obligation, or CMO, is a multi-class debt obligation that amortizes in relation to a specific pool of mortgages. Since its invention in June 1983, an event in which First Boston takes great pride, approximately $30 billion of CMOs have been issued. The success of the CMO structure illustrates the benefits that can be obtained by a multiple class security. The Multi-Class Pass Through Security that would be authorized by S. 1978 would likely be at least as successful a vehicle for securitizing all manner of obligations for two important reasons. First, because the CMO is a debt instrument, the same negative implications of borrowing that I spoke of earlier apply to CMOs. S. 1978's Multi-Class Pass Through Security, on the other hand, would allow for a sale of assets and therefore an improvement of the balance sheet. In addition, the Multi-Class Pass Through Security is inherently more efficient than a CMO. First, absent the constraints of current tax law, many CMOs would have been structured to have exactly matched the cash flows of the underlying mortgages. The more closely the cash flows from the pool of receivables match the payments to the investors, the more efficient the security.

Second, special purpose corporation CMO issuers would not have been arbitrarily capitalized were it not for the necessity of making certain that the CMOs were classified as debt and not as multiple class grantor trusts.It is First Boston's understanding based upon preliminary conversations with Treasury officials that Treasury is not opposed to the Multi-Class Pass Through Security concept and would not be opposed to the application of that concept to all types of assets assuming, of course, that the Multi-Class Pass Through Security and its application to all types of assets is at worst revenue neutral to the government. I understand that a representative of the Treasury will be testifying before the Subcommittee today on S. 1959 and S. 1978 and I defer to such representative to more fully explain Treasury's views on this matter. I will suggest, however, that it is to no one's advantage to continue to allow needless inefficiency to remain uncorrected.

The Importance of Non-Mortgage Receivables

Home ownership may be the American dream, but house ownership is not. To most people shelter without comfort is survival and not a dream. Losing that shelter because other financial demands result in an inability to make mortgage loan payments is a nightmare. It is clear that housing is not the only necessity. Decent health care, food, suitable clothing, furniture and home furnishings, and in most instances some means of transportation are modern life essentials.

The ability to obtain any or all of these items obviously is dependent on a number of factors, most of which are financially related. Our experience with securitizing mortgages tells us that accessing the capital markets results in greater availability of money for home building, lower mortgages rates and a stronger home building industry. Our more recent experience with securitizing other types of receivables leads us to expect similar results.

Receivables, whether they are secured by an interest in real property or secured by an interest in personal property or are unsecured, are surprisingly similar. Receivables are simply amounts owed to an entity by another. In the context of the typical mortgage loan, the loan payments are the obligations of the borrower and the receivables of the lender. The mortgage or security interest in the real property that is granted by the borrower to the lender is merely to secure borrower's promise to pay lender and becomes important only if borrower does not pay. In each instance, lenders will require borrowers to provide security for their promises to pay to the extent and in the amount they think necessary to protect the value of their receivable. The securitization process begins with developing a detailed understanding of the legal and financial terms of the receivables, including any security interest supporting the receivable. Based upon this analysis a security structure is devised to find the best possible accommodation of the characteristics of the receivable and the requirements of the investors. The reasons for this Subcommittee to support S. 1978 and place all types of receivables on a level playing field can be best illustrated by considering the following three receivables. S. 1978 would benefit all three receivables. S. 1959 would benefit only two.

All three receivables have a remaining term to maturity of 48 months, a current principal balance of $10,000 and an interest rate of 12% per annum. All three receivables are subject to prepayment.

Receivable 1 is a car loan that provides for 48 monthly payments of $263.34.

Receivable 2 is a seasoned single family mortgage loan that has remaining 48 monthly payments of $263.34.

Receivable 3 is an interest only commercial real estate loan that provides for 47 monthly payments of $100 followed by a payment of $10,000.

As illogical as it may seem, Receivable 1, the car loan, would be excluded from the benefits of your actions if you limit your concerns only to receivables secured by real estate mortgages. S. 1978 would apply equally to all three receivables and would not require making arbitrary distinctions.

The Need for Technical Corrections To The Tax Treatment of Mortgage and Asset Backed Securities

Incorporated into S. 1959 is an attempt to clarify by legislative action the application of certain tax code provisions to the Collateralized Mortgage Securities that would be authorized by that bill. In general the bill would adapt the application of the rules relating to original issue discount, market discount and premium, and stripped bonds which were drafted with traditional corporate securities in mind to the special case of obligations that may pay principal in installments, are subject to prepayment, and are collateralized by mortgages that pay monthly. Clarification of the application of these rules to all types of obligations is a task worthy of the effort. Uncertainty in this area works to no one's advantage, least of all Treasury's. Implied in S. 1978 is the proposition that, given the highly technical and narrow focus of these problems, perhaps they should be addressed at the regulatory level. In either case, whether the proper solution is legislative or regulatory, First Boston is willing to work with the Subcommittee and its staff, Treasury, issuers and others from Wall Street to find workable methods of applying these rules to all types of mortgage and Asset Backed Securities.

Conclusion

I support the efforts of this Subcommittee to facilitate the securitization of receivables of all types so as to increase the availability and lower the cost of credit while strengthening the financial condition of America's businesses and agencies. I believe that these efforts ultimately will have very positive effects on our economy. I strongly support S. 1978 and its authorization of the Multi-Class Pass Through Security for all types of receivables by all issuers. Finally, First Boston is willing to work with all interested parties to clarify the application of certain technical provisions to mortgage and Asset Backed Securities.

STATEMENT OF THOMAS A. KASPER, PRINCIPAL, MORGAN STANLEY & CO., NEW YORK, NY

Mr. **Kasper**. Mr. Chairman and Senator Long, Morgan Stanley welcomes the opportunity to appear today to discuss legislation which we believe will increase mortgage and capital market efficiencies. My name is Thomas Kasper. I am the senior investment banker in the mortgage products group at Morgan Stanley. Morgan Stanley has traditionally been an investment banker to many of the Nation's leading industrial corporations. They are a firm that is actively involved in all facets of fixed-income securities on a global basis, including mortgage securities.

Mr. Fink and Mr. Ranieri have ably pointed out the inefficiencies of current structures; and I think that that is worth mentioning again: That the CMO which has directly lowered the cost of mortgage credit has done so because we have taken uncertainty away from mortgage securities. Investors pay us more when we have less uncertainty, and those higher prices and lower yields have directly reduced the cost of mortgage credit to homeowners in a very real direct cost reduction in mortgage credit.

We want to extend that direct reduction in mortgage credit to other assets. We want the same power, the same techniques, and the same financial technology so we can give corporate America a new lease on life in its financing activities, because we all know that this last two decades have been periods of declining credit quality and increasing leverage among corporate America. And the techniques of the multiclass security to take receivables which, in the aggregate, have a higher credit quality than the credit of many direct issuers of debt or equity securities themselves, we are giving corporate America the most effective—cost effective—manner to decrease its cost of access to capital markets. To not extend this legislation to that, we believe, would be detrimental to many major corporations.

I don't think you can overestimate the power of this technology to take any self-liquidating, reasonably homogeneous receivable—and they have all been discussed here—we have an idea, they start with car loans and they go on—to package those receivables, to sell the security based on that, so that the user or the issuer of that security gets the benefit of lower cost funds; and the beneficiary of that will certainly be the consumer and the user of that corporation's products.

We welcome the opportunity to express these views, and we encourage this subcommittee to include not only some of the receivables here, but a broad-based group of other assets that can be used in the legislation here as 1978 has indicated. Thank you very much for your attention.

Senator **Chafee**. Thank you very much, Mr. Kasper.

Mr. Horner.

[The prepared statement of Mr. Kasper follows:]

TESTIMONY OF

THOMAS A. KASPER

PRINCIPAL

MORGAN STANLEY & CO.
INCORPORATED

NEW YORK, NEW YORK

Before the

Subcommittee on Taxation and

Debt Management

of the

Senate Finance Committee

on

January 31, 1986

Tax Treatment

of Mortgage and Receivable-Backed Securities

Introduction

Mr. Chairman and members of the Subcommittee, Morgan Stanley welcomes the opportunity to appear today to discuss legislation which we believe will increase mortgage and capital market efficiencies.

My name is Thomas A. Kasper. Over the past 10 years, I have been involved with virtually all facets of mortgage finance and mortgage securities. I am the senior investment banker in the Mortgage Products Group at Morgan Stanley. This group works with a broad range of users and suppliers of mortgage capital.

Morgan Stanley has traditionally been investment banker to many of the nation's leading industrial corporations (Exhibit 1). Today, our Firm is actively involved in the underwriting, distribution and trading of fixed-income securities, including mortgage securities, on a global basis. In 1985 Morgan Stanley was one of the five largest underwriters of mortgage securities.

The Market for Mortgage Securities

Mortgages and mortgage securities have exploded as capital market investments in the last decade. The total volume of mortgage securities outstanding has reached $300 billion. The vast majority of these securities have been mortgage pass-through types similar to the security pioneered by GNMA. These securities provide for the direct "pass-through" of virtually all underlying mortgage payments when received. As such, average life considerations and maturity uncertainty due to prepayments are investment characteristics which have, to some degree, impeded establishment of a broader universe of investors.

A revolution in mortgage securities occurred in 1983 with the "serialization" of mortgage cash flow to create debt securities with different maturities (Exhibit 2). These securities, called "Collateralized Mortgage Obligations" or CMO's are issued in classes with sequential payments. The mortgage cash flow is segmented so that earlier classes of bondholders receive priority and earlier pay-off. Later classes of bondholders receive subsequent payments and call protection. Uncertainty of payment is reduced for all classes. Because payment uncertainty is reduced, securityholders accept lower yields. These lower yields have directly and significantly lowered the cost of mortgage credit to homeowners.

The Need for Greater Efficiency

Even when CMO's are properly structured, they have inefficiencies which inhibit usage by a broader group of mortgage originators. These inefficiencies take several forms:

- Because CMO's are generally considered debt for tax and accounting purposes, many potential issuers are either prohibited or discouraged by regulation (banks) or financial practice (mortgage bankers) from using them.

- Since CMO's are considered debt as opposed to multiple class pass-through securities, they do not qualify as mortgage investments for some investors (thrift institutions).

- By necessity, CMO's have a complicated internal structure designed to achieve "AAA" ratings. This imposes additional transaction costs which are ultimately paid by the mortgage borrower.

We believe the legislative proposals before the Subcommittee will correct these inefficiencies so as to broaden the use of these securities and further lower the cost of mortgage credit.

In an effort to eliminate these inefficiencies, Sears Mortgage Securities Corporation issued a multiple class pass-through security in 1984. Sears received an opinion of counsel prior to issuance to the effect that the security was in compliance with existing grantor trust rules. The IRS disagreed and responded with proposed regulations. The regulations provided that the multiple class trust would be treated as a partnership or an association taxable as a corporation. The regulations were issued pursuant to the broad discretionary authority of the IRS and are not likely to be withdrawn. These proposed regulations received significant criticism in hearings held by the IRS on July 31, 1984. This criticism was not narrowly focused but included testimony from the Mortgage Bankers Association of America, the National Association of Homebuilders and the Public Securities Association.

Legislative Proposals

The Subcommittee has before it two legislative proposals to overcome the proposed IRS regulations. These legislative proposals, S. 1959 and S. 1978, would revise the present tax treatment of certain debt and pass-through securities. The two basic alternatives for liquification of mortgages are an asset sale, often by means of a pass-through security and a debt offering, such as a CMO. S. 1959 would accomplish these goals by devising a new REIT-type structure for both multiple class debt obligations and pass-through securities. It would also change existing tax law treatment of multiple class debt obligations. It would, at present, not include non-mortgage receivables and other assets.

Morgan Stanley believes the best solution would be one that is simplified in its approach and yet allows the use of non-mortgage receivables and other assets in a multiple class format. It is also our view that changes to existing law or extensive additions to existing law should be minimized. We believe that the Subcommittee, the Treasury, the Administration, the sponsors of S. 1978, and the Wall Street community should work together to develop a solution to these problems that is acceptable to all parties concerned.

We believe S. 1978 would accomplish these goals by authorizing, within the traditional grantor trust format, the use of multiple class pass-through securities. It would not affect the treatment of multiple class debt obligations. It would include non-mortgage receivables and other assets in such multiple class trusts.

Non-Mortgage Receivables and Other Assets

The cash flow generated by a variety of receivables can be structured to create marketable securities. Any group of receivables which are relatively homogenous and self-liquidating are candidates for securitization. In many cases, the techniques and financial technology can be borrowed directly from mortgage securities.

Examples of potential assets for securitization include: automobile loans; computer leases; contractural utility payments; credit card receivables; lease receivables; major appliance loans; mobile home loans; second mortgage loans; and term bank loans. The use of a multiple class pass-through structure will permit liquification of these assets in an efficient and cost effective manner.

These techniques offer tremendous opportunity for improving the financial health of a broad range of financial and industrial corporations. It is no secret that the 1970's and 1980's have been periods of increasing leverage and declining credit quality among major corporations. This trend has limited the access of many of these corporations to traditional sources of capital. The ability to pool and liquefy high-quality receivables in a multiple class pass-through security can reduce leverage and increase credit quality. The cost of capital and credit will be reduced. These reduced costs will benefit the general public.

Inclusion of the Federal Agencies

It would be difficult to overstate the importance of the Federal housing credit agencies - GNMA, FNMA and FHLMC - in facilitating the creation of mortgage capital. The agencies have been leaders in the creation of new mortgage securities, as GNMA did 15 years ago with the first pass-through security and FHLMC more recently with the first CMO. They have been leaders in opening new markets for mortgage capital, as FHLMC and FNMA have done internationally. To exclude the agencies from the proposed legislation would blunt private sector initiatives.

Conclusion

The efforts of the Subcommittee are a promising step in increasing mortgage and capital market efficiencies. We believe enactment of legislation to permit the issuance of multiple class pass-through securities, including non-mortgage receivables, is vital. Morgan Stanley is ready to work with Congress, the Treasury, the Administration and the Federal agencies in developing these initiatives. Thank you for the opportunity to express our views today.

EXHIBIT 1

THE NEW YORK TIMES, FRIDAY, JANUARY 24, 1986

COMPANY NEWS

A Firm for the Blue-Chip Elite

By LESLIE WAYNE

More than any other firm, Morgan Stanley & Company epitomizes Wall Street's blue-chip elite.

The firm traces its roots to J. P. Morgan & Company, a private bank founded in 1895 by J. Pierpont Morgan. But the brokerage that exists today was founded, in essence, by a stroke of Congress. The Banking Act of 1933, designed to eliminate the speculative excesses that led to the stock market crash in 1929, mandated a separation between the commercial banking business and the securities business. And, as a result of that act, Morgan Stanley Inc. was founded in 1935.

The firm was named for its founders: Mr. Morgan himself and Harold Stanley, a Morgan associate who broke with the private bank to form the new brokerage. In the style that later came to typify the firm, announcement of the new firm's birth was made in front of a large fireplace in the bank's main room at 23 Wall Street.

Ties to Corporate Elite

From the start, the firm was a success, underwriting a $19 million utility bond in its first week and managing some $1.1 billion in underwritings in its first year of operation. Since then, it has parlayed its considerable ties with the top tier of corporate America into a powerful underwriting franchise that few could break.

Throughout the 1940's and the 1950's, Morgan raised money for America's rapidly growing corporate giants, and today the firm's client list is the envy of Wall Street: American Telephone and Telegraph, General Electric, Exxon and Du Pont. It made its fortune by dispensing advice — often at lunches in its opulent dining rooms — and by guiding corporations through the underwriting process. Indeed, for decades, it was a mark of prestige to have the Morgan imprimatur on a corporate issue, and the firm maintained a mystique that enabled it to justify its huge banking fees.

Morgan is a firm that historically specialized in pure investment banking, acting as an investment adviser to corporate treasurers as they attempted to raise the money to finance their activities. Its entrance into the rougher, and highly profitable, world of trading is measured in years, not decades. It traditionally recruited from the elite of the Ivy League and let the street-smart find their ways to other firms. And it has shunned the wide-ranging retail distribution networks that Merrill Lynch or E. F. Hutton maintain.

Yet the world around Morgan has changed. The consolidation of brokerage firm that swept through Wall Street after the deregulation of fixed brokerage commissions on May Day 1975 brought in new financial competitors and made capital an even more powerful commodity on Wall Street than ever before. Wall Street was changed from a place where only old school ties mattered to an age marked by a trading and transactions orientation.

And, in this environment, Morgan Stanley has changed, too. in the late 1970's and through the 1980's, it began to recruit a broader array of bankers, those with modest origins and high ambitions. It now allows others to co-manage underwritings of its corporate franchise, a departure from its traditional rule of being the sole manager for industrial underwritings.

Hotly Competitive Business

Recent forays in this hotly competitive financial world have taken Morgan into the mortgage-backed securities market and have made it an active participant in mergers and leveraged buyouts. However, it was slow in issuing and trading commercial paper and tax-exempt securities, giving its competitors decades to establishprofitable beachheads.

The firm's heads today represent both the old and new face of Wall Street: the chairman, S. Parker Gilbert, the son of a J. P. Morgan partner, is a Yale-educated traditional investment banker. In the No. 2 position, Richard B. Fisher, is a Princeton-Harvard man who has been active in pushing the firm more into trading.

These two men steered Morgan now based far uptown from Wall Street in the Exxon Building, to its best performance ever. For 1984, the most recent year for which figures are available, the firm, which has some 4,000 employees, had revenues of $600 million, and its capital is estimated to be around $500 million.

MORGAN STANLEY

Wall Street on mortgages

CMOs Fix Mismatches

by **THOMAS A. KASPER,** *manager*
mortgage finance group
Morgan Stanley & Co., New York

Mortgages and mortgage securities have exploded as capital market investments in the last decade. The total volume of mortgage securities outstanding approaches $300 billion.

The vast majority of these securities have been mortgage pass-through types. Such securities provide for the direct pass-through of virtually all underlying mortgage payments received. As such, average life considerations and maturity variance due to the uncertainty of prepayments are investment characteristics which have, to some degree, impeded establishment of a broader universe of investors.

A revolution in restructuring mortgage securities into bonds occurred in 1983 with the issuance of collateralized mortgage obligations. This restructuring involved the "serialization" of the cash flow from mortgages and mortgage securities into bonds issued in several classes with sequential principal payments. Because the bonds had shorter final maturities, financing costs were reduced by pricing such bonds along a positive Treasury yield curve. To date, more than $14 billion of CMOs have been issued in public offerings.

PORTFOLIO STRATEGIES

The CMO is a logical extension of the efforts to restructure mortgage cash flow. The cash flow from a collateral pool of mortgage securities or mortgages is the credit support for principal and interest on the bonds. However, the cash flow is allocated to different maturities sequentially.

Through the segmentation and pledging of mortgage cash flow, the CMO structure provides savings institution issuers with two important characteristics to maximize the value of pledged collateral. First, pricing a series of bonds along a positive Treasury yield curve reduces financing cost. Second, pledging (as opposed to selling) collateral provides for excess cash flow (in excess of debt service) upon mortgage prepayment. In effect, the present value of this excess cash flow is equivalent to greater net proceeds. The excess cash flow reverts to the issuer and is an important component in reducing financing costs.

Managing mortgage cash flow to create securities with different maturities and payment features offers an endless variety of portfolio strategies to correct the traditional savings institution liability mismatch. Since the CMO is a nonrecourse "cash flow" credit, an institution can convert any mortgage asset into a pure financing cost for reinvestment analysis. Importantly, the "stand alone" CMO credit has no refinancing risk. The maturity of the asset converted into a CMO and the net CMO cost provide the two key numbers for comparative analysis.

Several broad strategies will correct the traditional asset and liability mismatch of savings institutions:

(1) Convert long-term fixed rate mortgages into CMOs and reinvest the proceeds into fixed rate assets with shorter maturities. Frequently, this transaction can be done at a yield pick-up and, potentially, with an improvement in portfolio liquidity.

(2) Convert long-term fixed rate mortgages into CMOs and reinvest the proceeds into floating rate assets, such as adjustable rate mortgages. This has the positive portfolio effect of converting long-term assets into long-term debt to fund interest-rate-sensitive assets.

(3) Convert long-term, fixed rate mortgages into CMOs where specific liabilities fund specific assets. CMO proceeds can be targeted so that the term of each CMO class match funds an asset with a comparable term or average life.

Most CMO issues have been structured so that, given the prevailing prepayment assumption, the various classes can be priced off Treasury securities with comparable terms. The average life assumption of each class is the important benchmark for pricing.

Maximizing the value of a collateral pool in a CMO issue (minimizing total CMO cost) is a complex interaction of a number of variables. Constant monitoring of these variables is necessary. Six of these variables or parameters are:

(1) **Discounting method.** Several methods of discounting or valuing CMO collateral have been used in offerings to date. Their relative complexity is directly correlated with their "efficiency" (how much "borrowing power" can be derived from a fixed collateral pool).

The simplest but least efficient method is the coupon-to-coupon or "current yield" method. Each mortgage security is assigned a collateral or "bond value" based upon the ratio of its coupon to the highest CMO "bond coupon." The most complex but most efficient method is the "yield to maturity" method. In this case, the collateral or bond value is based upon a discount to maturity of each mortgage or mortgage security at the high CMO bond coupon.

At par, of course, yield to maturity and current yield are identical. However, as mortgage collateral diverges from par

Here are tricks of the trade in CMO pricing and structure

Kasper is manager of a Morgan Stanley group, integrated with the firm's mortgage sales and trading efforts, that works with mortgage security issuers to help them access capital markets.

(discount collateral in particular), it is clear that the discount to maturity valuation method becomes more efficient — it results in greater net proceeds or borrowing power.

(2) **Yield levels.** The shape and absolute level of the Treasury yield curve will significantly affect the optimum CMO structure. Clearly, the economics are most favorable when the yield curve has a significant positive slope.

(3) **Final maturities and sizes.** The relative size and final maturity of each class involves a tradeoff which may affect the optimum structure, depending on reinvestment strategies. Decreasing final maturity of early classes to take advantage of a positive yield curve will result in smaller relative par amounts of these classes and larger relative par amounts of the longer higher coupon classes. The weighted average CMO cost which results must be tested for sensitivity to these variations.

(4) **Prepayment assumption.** The FHA prepayment assumption used to compute average lives of each bond class will affect CMO cost. The higher the prepayment assumption on the underlying collateral, the shorter the average life of each class. Shorter average lives permit pricing off shorter-term Treasury benchmarks. The permissible prepayment assumption will be largely market determined. Clearly, the average collateral coupon rate and the perceived rate of future prepayment will be important factors in this market assumption.

(5) **Reinvestment rate.** The CMO issuer will collect mortgage payments monthly and generally remit payments to bondholders semiannually. The permitted reinvestment rate on monthly cash flow will be determined by the credit rating agencies. Guaranteed reinvestment agreements from high-credit institutions at higher rates will enhance the borrowing power of a fixed collateral pool.

(6) **Discount rate for excess cash flow.** Excess cash flow results from the difference between aggregate collateral payments collected and bond payments remitted. This excess can result from the periodic return of overcollateralization due to prepayments (the principal portion) and the earnings spread (the difference between CMO interest cost and collateral yield — the interest portion) or a combination of both. The discount rate used to value the excess cash flow will impact the net cost of funds and, accordingly, the CMO's economic value.

UNFORSEEN CONSEQUENCES

In 1981, the FHLBB issued regulations which permitted federal institutions to sell assets, particularly long-term, fixed rate mortgages, and defer losses for regulatory accounting purposes. Much activity resulted as many institutions sold long-term, fixed rate mortgages to reinvest the proceeds in shorter term or more rate-sensitive assets.

This strategy proved beneficial in many cases but had several unforeseen consequences. First, as sellers, institutions were subject to the relative illiquidity of the whole loan market in executing transactions. Second, the sale of discount mortgage loans generated large losses under generally accepted accounting principles. Sales resulted in negative net worth for some institutions. Negative net worth under GAAP impeded access to the market for much-needed equity capital.

The CMO provides an improved portfolio strategy for correcting the asset and liability mismatch. The liquidity of the CMO market vastly exceeds the whole loan market. More importantly, the CMO structure cuts the cost of funds by segmenting cash flow in a positive yield curve environment and providing for excess cash flow from prepayments.

As a secured financing, the CMO permits liquification of low-rate mortgages without accounting losses. Access to equity capital markets is not hindered by accounting issues. The CMO enables a strategy that improves portfolio balance, enhances earnings and increases access to equity capital markets.

STATEMENT OF ROBERT HORNER, CHAIRMAN, SEARS MORTGAGE CORP., LINCOLNSHIRE, IL

Mr. **Horner**. Good morning, Mr. Chairman, Senator Long. I am Bob Horner, chairman and chief operating officer of Sears Mortgage Corp. and executive vice president of Dean Witter Financial Services Group. I appreciate this opportunity to submit the views of Sears, Roebuck and Co. this morning with respect to S. 1959, the secondary market tax amendments, and S. 1978, the Recovery Act for mortgages and other asset-backed securities. I will be summarizing the remarks contained in our written statement, Mr. Chairman, and therefore request that my complete statement be made part of the record.

Senator **Chafee**. It will.

Mr. **Horner**. Sears is committed to the development of the secondary mortgage market and would like to emphasize that there exists today a critical need for Congress to support the development of this market. This can be accomplished by clarifying the current tax law, thus permitting the market to expand. The result, we believe, will be the additional capital needed to fund current and projected housing needs.

Mr. Chairman, Sears is also committed to supplying low cost mortgage credit to customers. Five Sears subsidiaries, Caldwell Banker, Residential Mortgage Services, Dean Witter, Sears Savings Bank, All-State Enterprise Mortgage Corp., and Sears Mortgage Securities Corp., provide mortgages and related services to the mortgage credit supply chain.

As an active participant in housing finance, we have continually worked to bring about changes that may bring more affordable mortgage costs to home buyers. You might recall, Mr. Chairman, that in early 1984, Sears Mortgage Securities Corp., along with Dean Witter, offered the first multiple class pass through mortgage-backed securities. Premised upon a private letter ruling from the Internal Revenue Service, the securities were established under existing grantor trust rules with multiple classes of ownership. A short time after the establishment of the multiple class pass through, the Internal Revenue Service issued proposed regulations which took a view opposite from the earlier private letter ruling and stated that multiple classes of ownership and the underlying pool of mortgages violated the passed requirements of the grantor trust rules.

Sears believed at the time, when we issued our multiple class pass through, that this type of instrument was the most effective and economically efficient means of raising mortgage money for the mortgage and housing industry in America. We still hold this belief. That is why we support the legislation before the subcommittee. The benefit to the housing industry of the mortgage backed multiple class passthrough will be substantial. Because of competition, the economic benefit to issuers will be passed on to the home owners as a lower cost of financing home purchases. If allowed, we believe that the multiple class pass through would become the preferred method of selling mortgages in the secondary market because it is often economically more efficient than any other alternative currently available.

Our studies indicate that the net economic benefit to an issuer selling mortgages in the form of multiple class pass throughs as compared to the next best alternative is at least one-quarter to one-half percent in the rate of interest.

Now, Mr. Chairman, I would like to briefly comment on S. 1959 and S. 1978. Although Sears supports both bills, we believe that your bill contains the more direct and complete answer to the issues existing in today's mortgage securities marketplace. In addition, your bill goes a long way to eliminate other impediments to the use of multiple class pass throughs. The changes proposed today have the keys to accomplishing the goal of providing home affordability. Sears supports enactment of legislation dealing with mortgage securities for three reasons. The legislation would permit multiclass ownership interest in mortgage collateral. The legislation more clearly defines a precise method of computing original issue discounts; and the legislation would enable purchases of CMO's to be treated as investments in mortgages under the Tax Code, thereby expanding the market for such securities.

We view the proposed legislation as fair and vital to the continued expansion of the secondary mortgage market and the provision of additional capital to meet the demand for mortgage credit. And thank you for this opportunity.

Senator CHAFEE. All right. Thank you very much, Mr. Horner. Mr. Rush?

[The prepared statement of Mr. Horner follows:]

Statement of

Robert D. Horner

on behalf of

Sears Mortgage Corporation

A Subsidiary of

Sears, Roebuck and Co.

before the

Senate Finance Subcommittee
on Taxation and Debt Management

on January 31, 1986

Mr. Chairman and members of this distinguished Subcommittee:

My name is Robert D. Horner. I am Chief Executive Officer of Sears Mortgage Corporation and am testifying today on behalf of Sears, Roebuck and Co.

I appreciate the opportunity to appear before this Subcommittee today.

Before commenting on Senate Bills S.1959 and S.1978, I would like to emphasize that there exists today a critical need for Congress to support the development of the secondary mortgage market. This can be accomplished by permitting the market sector to expand, thereby providing the additional capital needed to fund current and projected housing financing needs.

Home ownership holds a critical place in our nation's system of values, and there is ample evidence that such ownership contributes positively to those values. The purchase of a home is usually a consumer's largest single investment. Funding home purchases through an efficient secondary mortgage market is extremely important in allowing people to realize home ownership goals.

The demand for home mortgage credit cannot be provided solely by historical funding sources -- portfolio lenders.

Statistics confirm that institutional investors other than those who originate loans have in recent years become substantially more important to the housing industry. For example, according to the Federal Home Loan Mortgage Corp., in 1970, 33 percent of all mortgages written were immediately resold to institutional investors. By 1983, that percentage had risen to 61 percent. Therefore, in today's market there is tremendous pressure to facilitate the sale of mortgages to institutional investors in order to supply mortgage credit to consumers at a reasonable and efficient cost.

In addition to raising funds through institutional investors, it is possible that a properly structured multi-class pass-through certificate ("MCPT") could be sold to individual retail investors. This would act to further expand the potential supply of mortgage credit and lower mortgage rates for homeowners.

Sears Mortgage Securities Corporation and our affiliates, Dean Witter Reynolds Inc., Coldwell Banker Residential Mortgage Services, Sears Savings Bank and Allstate Enterprises Mortgage Corporation, have watched intently the legal, regulatory and legislative developments affecting mortgage securities for the past three years. As an active participant in housing finance we have continually worked to bring about changes that may bring more affordable mortgage costs to homebuyers. These changes have been proposed in the form of Trust for Investment in Mortgage ("TIM's"), The Deficit Reduction Act of 1984, The Secondary Mortgage Market Enhancement Act ("SMMEA"), which was actually enacted, and finally, the two bills which are currently before this Subcommittee.

A. Sears Participation in the Mortgage Market

Sears is committed to supplying low cost mortgage credit to consumers. Four Sears subsidiaries, Coldwell Banker Residential Mortgage Services, Sears Savings Bank, Allstate Enterprises Mortgage Corporation ("AEMC") and Sears Mortgage Securities Corporation ("SMSC"), function in two different areas of the mortgage credit supply chain. Coldwell Banker Residential Mortgage Services, Sears Savings Bank, and AEMC originate mortgages through their branch offices. In addition, they are currently exploring other mechanisms for delivering mortgages in a more efficient manner, such as telemarketing and in-store application taking. In total, this group, having originated approximately $3 billion in mortgages in 1985, represents one of the largest mortgage providers. Sears, through substantial investment and through innovative management is establishing a competitive position in the mortgage industry by offering low cost mortgages to homebuyers.

SMSC acts as a conduit to the capital markets for mortgage providers. That is, it purchases loans from a number of sources, including affiliates as well as other mortgage bankers, savings & loans and other lending institutions, packages them into securities, and sells them to investors, often through another Sears affiliate, Dean Witter Reynolds Inc. In the same fashion as its mortgage origination affiliates, SMSC has invested capital and management resources in order to position itself as a provider of low cost mortgages to its affiliates and other institutions. In fact, in 1985, SMSC purchased over $1 billion in home mortgages, infusing more capital into the industry.

A critical element to Sears and other mortgage providers is efficient execution of the securities so that the best mortgage rate can be obtained for borrowers. Currently, the most effective and economical security is the MCPT. As I'll mention later, the net economic benefit to an issuer selling mortgages in the form of MCPTs, as compared to the next best alternative, the collateralized mortgage obligation ("CMO"), is at least one-quarter to one-half percent of the principal amount of the mortgages.

The benefit to the housing industry of the MCPT will be substantial. Because of competition, a substantial portion of the economic benefit to issuers will be passed on to homeowners in the form of lower cost mortgages.

B. The SMSC Multi-Class Pass-Through, Series 1984-1

In conjunction with our affiliate Dean Witter Reynolds Inc., SMSC filed a registration statement with the Securities and Exchange Commission (the "Commission") for one billion dollars in January, 1984, and issued $500 million of multi-class pass-through certificates in February, 1984. This was accomplished after extensive research and analysis of the "grantor trust" provisions in the Internal Revenue Code of 1954, as amended ("the Code"), and after receipt of opinions from outside counsel to the effect that the transaction would be treated as a sale of assets pursuant to the grantor trust provisions of the Code. Several privately-placed multi-class issues had been successfully placed before Sears' filing of the registration statement. This registration statement provided for a multi-class pass-through security, structured to provide classes of certificates with differing maturities to meet different investors' maturity needs.

After the successful sale in late February, 1984, of the $500 million AAA-rated certificates (the "Series 1984-1 Certificates") on February 28, 1984, preparations began for Series 1984-2. A preliminary prospectus supplement was filed with the Commission on April 19, 1984. On April 27, 1984, just prior to pricing the Series 1984-2 issue, Proposed Regulations were issued by the Treasury Department, prohibiting treatment of the issuance of certificates as a grantor trust pass-through transaction, and requiring that the trust be taxed as a corporation. This treatment resulted in taxation of the mortgage cash flow at both the trust pass-through level and at the investor level, rendering the pass-through structure useless. Sears stopped all work on the proposed Series 1984-2 offering, and still has on file with the Commission the remaining $500 million of the registration statement. The proposed regulations and their dramatic impact on the mortgage capital markets have come to be known as the "Sears Regs".

Despite correspondence with and testimony before the Treasury Department by Sears, Dean Witter and other participants in the mortgage securities market (including Norwest Mortgage, the National Council of Savings Institutions, the Mortgage Bankers Association, the National Association of Realtors and the National Association of Home Builders), the Proposed Regulations remain in place.

The issues raised by the Sears Regs are ones that we believe are properly before Congress -- as opposed to being addressed in regulations proposed by the IRS -- since they involve policy issues not found in current statutory guidelines. We are therefore pleased to see Congress addressing these issues in the proposed legislation and at this hearing.

C. Advantages of the Multi-Class Pass-Through Structure

The MCPT is the preferred form of investment in mortgages due to the characteristics of its structure. The MCPT structure is based primarily upon the mortgage pass-through security. In a pass-through, the conduit (GNMA, FNMA, FHLMC or a private conduit such as SMSC) receives principal and interest payments from homeowners, and passes these payments through to investors. However, for the MCPT, the conduit further partitions the mortgage cash flow to create several classes with different expected maturities and different exposure to call risk.

Each MCPT issue is divided into three or more classes or "tranches". The final class is typically an accrual class that receives no payments until all the earlier classes are retired. Interest is paid (or accrued) on all classes but principal is only paid to holders of the first class until that class is retired and thereafter principal is paid to the second class, and so forth until the last class is retired.

MCPTs enable investors to manage and, in most cases, reduce their exposure to the prepayment risk occuring due to the mortgagor's call option. In addition, MCPT classes are compared against corresponding Treasury bonds, allowing more accurate valuation of the overall security.

The MCPT also provides for quarterly or semi-annually payments to investors, which are preferred over the monthly payments of pass-through securities.

With the introduction of the "Sears Regs," the CMO became the next best alternative to MCPTs. The CMO incorporated the multi-class structure, quarterly or semiannual payments and the other features of the MCPT. However, the CMO has several disadvantages relative to the MCPT. First, the structure requires that debt be carried on the books of the parent corporation under certain circumstances, prohibiting many mortgage providers from using this structure. Ironically, one of the criteria which allows the debt to remain unconsolidated is if the parent corporation can claim that the issuing subsidiary is not in a business similar to the business of the parent. This criteria penalizes business in the mortgage-providing industry and effectively prohibits institutions such as mortgage bankers from funding mortgages in an efficient manner and requires that securities firms establish increasingly complex structures to meet the accounting criteria. Despite the debt treatment of the CMO issuer, investors still look to underlying mortgages for collateral just as they would in a multi-class pass-through because the subsidiary issuing a CMO is a thinly capitalized shell corporation which can provide no financial assurances to investors.

The second disadvantage of the CMO is that it requires capital investment in the subsidiary in order for the security to be considered debt. Although this capital investment is small relative to the size of CMO issued and provides little security to investors, it does require a significant investment by the issuer. As a result, even for those who can in theory borrow substantial amounts of money collateralized by mortgages (i.e., thrifts), the MCPT is much more attractive than issuing a multi-class debt security collateralized by mortgages (a CMO).

Finally, the issuance cost of a CMO is significantly higher than the issue cost of a MCPT because the structure is more complex and requires additional efforts by underwriters, accountants and counsel.

Despite the relative disadvantages of CMOs, in many cases these securities still are a more efficient instrument than single class pass-throughs for accessing capital market funds. As a result, the CMO has grown since its introduction in 1983 to become a viable tool for bringing more capital from private investors into the housing finance arena. In 1985, total CMO volume exceeded $17 billion, as compared to total government-guaranteed mortgage securities volume of approximately $100 billion. Half of the total for new mortgage originations is now converted into a security form for ultimate sale to public and private investors.

It is therefore easy to recognize the importance of securitization and sale of mortgages to public investors as a source of capital. Sears believes that the objective of Congress in addressing mortgage securities legislation should be to expand the number of investors, the supply of available mortgage capital and consequently the affordability of home ownership.

D. The Proposed Legislation

Although Sears supports both bills, we believe that Senator Chafee's bill (S.1959) contains more direct and complete answers to issues existing in today's mortgage securities marketplace. In addition, S.1959 goes a long way to eliminate other impediments to the use of MCPTs. The changes proposed today have the keys to accomplishing the goal of providing home affordability. Sears supports enactment of legislation dealing with mortgage securities for three reasons:

First, legislation should permit multi-class ownership interests in mortgage collateral. This is important because a broader group of mortgage originators, including mortgage bankers, banks, thrifts and conduit issuers, want to sell mortgages in the multi-class structure preferred by investors. Currently, the treatment of CMOs as debt prevents these originators from accessing this market, since the debt would be reflected on their balance sheet. Further, CMOs classified as debt for tax purposes require the issuer to retain an equity interest in the mortgages, thus preventing the issuer from obtaining the full value of the collateral at the time of the CMO sale.

Second, the bill more clearly defines the precise method of computing original issue discounts on CMOs. This clarification will provide a more accurate method for computing the actual taxable income or loss, thus guaranteeing both the Treasury and the investor fair tax treatment.

Third, the bill would enable purchases of CMOs to be treated as investments in mortgages under the Code, thus allowing a broader group of investors to purchase the instruments.

E. Conclusion

Sears believes that the proposed legislation, if enacted, would reduce the cost of capital to mortgage originators by at least one-quarter to one-half percent.

The benefits of CMOs are many, as evidenced in their rapid growth over a short period or time. The disadvantages are their increased cost, their treatment as debt of the issuer, their uncertainty as qualifying real estate assets and the lack of definitive guidelines for reporting taxable income or losses arising from mortgage prepayments. All these disadvantages can be cured by this legislation.

We view the proposed legislation as fair and vital to the continued expansion of the secondary mortgage market and the provision of additional capital to meet the demand for mortgage credit.

STATEMENT OF MICHAEL C. RUSH, MANAGING DIRECTOR, SHEARSON LEHMAN BROS., NEW YORK, NY

Mr. RUSH. Thank you, Mr. Chairman, Senator Long. My name is Mike Rush. I am a managing director with Shearson Lehman Bros., a subsidiary of American Express. I would like to concentrate my comments in the four areas in which Shearson Lehman Bros. support this legislation.

First is the authorizing of the multiclass class passthroughs within the rules of grantor trust rules? Second, providing a reasonable means to treat original issue discount consistent with treatment accorded to single class passthrough. Third, providing the benefits of the multiclass pass through to nonmortgage assets. And finally, allowing the access of Government-sponsored agencies to the same benefits accruing to multiclass passthrough issuers.

The granter trust has been a traditional financing vehicle that has served the industry well, but it is played to a limited audience. Due to the unpredictability of mortgage repayments, many investors could not match their portfolio requirements with single class passthroughs. Investors stayed within the family, that is, thrifs were the predominant investors, and the flow of capital tended to stay within the mortgage industry. Repackaging the single-class passthrough into discrete cash flows of a multiclass will bring more investors into the mortgage area. The success of CMO's, collateralized mortgage obligations, has demonstrated the value of distributing cash flows to various investors. Multiclass passthroughs can only have a beneficial effect on interest rates as more varied sources of capital flow into the mortgage marketplace.

The multiclass passthrough concept is essentially a variation on a theme. It is not a radical departure from the single class. One can use the analogy of a conglomerate here. The parts of the multiclass passthrough are worth more in value than the whole. Both the issuer, such as a thrift, and investor, such as a pension fund, can meet their respective goals more efficiently. Multiclass passthrough is not the divergence from the effect and trust of a single class, but rather a logical extension.

In the area of nonmortgage assets, the key to financial firms today is liquidity. Securitization allows greater liquidity on the balance sheet. Trades will be made on a standard basis among investors, issuers who work by agreed-upon rules. Given the new and varied roles our financial institutions are playing today, multiclass passthrough treatment should be applied to other assets to enhance liquidity, flexibility, and efficiency of the institution in supporting its various asset bases. The purchase and sale of nonmortgage assets will be improved through multiclass passthrough treatment with ultimate effects beneficial for the liquidity of our financial institutions.

On the third point, I would like to use the word "innovation." Innovation has been a key to the mortgage business. No greater innovative role has been played in the mortgage business than the roles played by Freddie Mac, Fannie Mae, and Ginnie Mae. The agencies have been givers, not takers. They have been bellwethers for many new products and have acted as a sounding board to the mortgage makers in particular. Freddie Mac and Fannie Mae have a reservoir of knowledge about the mortgage business that would be imprudent not to tap. Let's not forget that the mortgage business is their only business. They do not have the luxury of a Ford motor to buy a thrift or the ability to open a branch. The participation of Freddie Mac and Fannie Mae under the same rules as other issuers can only improve the multiclass passthrough marketplace.

All of us want affordable quality housing. The agencies have helped make that a reality. They have made us the best housed Nation in the world. We should continue to take advantage of their efficiency and contributions in the mortgage marketplace.

Mr. Chairman and Senator Long, thank you for this opportunity.

Senator CHAFEE. Thank you all for your testimony.

[The prepared statement of Mr. Rush follows:]

Shearson Lehman Mortgage Securities

SHEARSON
LEHMAN
BROTHERS

An American Express company

STATEMENT OF

MICHAEL C. RUSH

MANAGING DIRECTOR

SHEARSON LEHMAN BROTHERS, INC.

before the

Subcommittee on

Taxation and Debt Management

of the Senate Committee on Finance

on

Mortgage Related Securities

January 31, 1986

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Member of all principal security
option and commodity exchanges

Introduction

Mr. Chairman, my name is Michael Rush and I am a Managing Director with Shearson Lehman Brothers, Inc. in New York City. Prior to that I served as Senior Executive Vice President and Chief Operating Officer of the Federal Home Loan Mortgage Corporation. I am appearing today on behalf of Shearson Lehman Brothers, Inc., which is a subsidiary of the American Express Company.

Shearson Lehman Brothers believes strongly in the need for legislative action in the area of mortgage related securities. Since 1982 when the President's Commission on Housing published its report and suggested statutory tax changes to assist the development of the mortgage-backed securities markets, a consensus has been growing about the necessity of clarifying the taxation of securities in this area. The Administration has previously expressed general support for action but has yet to endorse any specific legislation.

Shearson Lehman Brothers supports legislation to:

I Authorize the issuance of multiple class passthroughs (MCPTs) within the grantor trust rules;

II Provide any reasonable means acceptable to the Congress and the Treasury Department of calculating the original issue discount on MCPTs that would be consistent with the treatment accorded single class pass-throughs;

III Allow non-mortgage issuers to benefit from the MCPT concept as well, including commercial banks, consumer finance companies, automobile finance companies, credit card companies, retailers, lessors of equipment and other owners of assets eligible for securitization;

IV Permit equal treatment for the government sponsored agencies such as the Federal Home Loan Mortgage Corporation ("FHLMC") and the Federal National Mortgage Association ("FNMA") to issue MCPTs.

I ISSUANCE OF MULTIPLE CLASS PASS-THROUGHS

The vehicle for selling interests in fixed pools of assets to investors has been a trust arrangement characterized as a "grantor trust" for Federal income tax purposes. If a trust qualifies as a grantor trust, its existence is basically disregarded for tax purposes, with the conclusion that the owners of interests in the trust are treated for tax purposes as owners of proportional interests in the underlying assets.

Therefore, an owner of an interest in a pool of assets is treated as owning a fractional undivided interest in each loan in the pool and is taxed on its pro rata share of income arising with respect to the assets.

Treatment of the trust as a "grantor trust" or "fixed investment trust" is essential for a trust holding a pool of assets. Otherwise, it would likely be considered to be taxable as a corporation for Federal income tax purposes. The result would be a tax at the entity level on all interest and discount income, and an additional tax to the holders of interests in the entity upon distribution of cash to them.

The principal requirements that had to be satisfied to maintain a trust's status as a fixed investment or grantor trust are (1) no substitution of assets,and (2) no active management of the cash flows for the benefit of certificate holders.

The greatest use of grantor trusts has been in the issuance of pass-through securities in the secondary mortgage market. One obstacle to expansion of the use of the trust structure in connection with the issuance of mortgage-backed pass-through securities has been the cash-flow characteristics of the mortgages themselves. Mortgages pay monthly, are subject to repayment at any time, and have a maturity of as long as thirty years. A purchaser of a pass-through security must purchase the entire stream of cash flows to be received over the life of the underlying mortgages. Because investors often have preferences as to the maturity and predictability of the payment streams of their investments, mortgage investments have been less attractive than other securities. Short-term investors have not been attracted to mortgage securities because of their long average lives and final maturities. Long-term investors find the absence of call protection unattractive.

The repackaging of mortgage cash flows into separate cash flows in a MCPT involves the creation of two or more classes of interest in the cash flows. The interest received on the mortgages would be distributed to the holders of the various classes of the mortgage cash flow in accordance with their percentage interest in the principal of the mortgages. Principal received from the mortgages, however, would not be distributed pro rata. Instead, the holders of a specified class of ownership in the pool would receive all principal until their ownership in the pool has been retired. Subsequently, all other classes of interests in the pool would be retired in order of their priorities.

This allocation of cash flows, while not providing complete certainty of timing of receipt of principal, narrows considerably the range of time over which the investor will receive principal. This concept, often referred to as fast pay/slow pay, has been the goal of architects of the secondary mortgage markets for almost a decade. The goal was partially accomplished in 1983 with the creation of the collateralized mortgage obligation ("CMO"). It is a debt instrument, the payment of which is secured by mortgages pledged as collateral for the debt instrument. The sale of multiple classes of ownership interests in mortgages through a grantor trust was used in one successful offering and then halted by proposed Department of the Treasury regulations.

In endeavoring to implement the fast pay/slow pay concept with respect to mortgages, it is necessary to ascertain whether such a concept is consistent with the grantor trust rules. It has not been clear whether or not only a single class of interests in a grantor trust is permitted, each with an identical fractional undivided interest in the entire pool of mortgages. The argument in favor of such a requirement is that it is inherent in the very conclusion that holders of a grantor trust are deemed to own the underlying mortgages. The MCPT structures seem inconsistent with that view since they involve allocations of cash flow from the pool as a whole, and no holder can be considered to own an interest in any particular underlying mortgage. Furthermore, such an allocation of cash flow might be considered inconsistent with the historically passive nature of grantor trusts. On the other hand, the argument for grantor trusts with multiple classes of ownership is that, previously, the only requirement of a grantor trust imposed by law or regulation has been that a fixed pool of mortgages (or any other assets) exist with no or very little reinvestment. It is our view that MCPTs are consistent with the grantor trust structure.

In 1983, FHLMC developed a unique fast pay/slow pay structure to be treated as a sale of assets for accounting purposes but as debt of FHLMC for tax purposes. It sought the best of both worlds. The IRS warned against the issuance of such a deferred instrument.

In early 1984 Sears Mortgage Securities Corporation sold interests in a MCPT. Subsequently, the IRS issued proposed regulations that stated a fixed investment or grantor trust can have only one class of ownership.

Despite these interpretations, it is our view that MCPTs are consistent with the grantor trust structure.

II ORIGINAL ISSUE DISCOUNT ("OID")

In fixed investment trusts with either one class of ownership or a MCPT, OID is the amount by which the face or maturity amount of a certificate of beneficial interest in a trust purchased by an investor from the issuer exceeds the investor's purchase price. In both a MCPT and a single class pass-through, OID is generated by the investor's purchasing a trust certificate at a yield other than the certificate's stated yield. However, the difference between a MCPT and a single class pass-through is that, in a single class trust, all investors realize or accrue OID income at the same rate over the same time period. In a MCPT, because the timing of the return of principal varies among the different classes to reflect the differences in investment risk, investors will realize OID income at different rates and/or over different periods of time. Such OID should be recognized by such investors as economically accrued during the term of the investment consistent with existing Treasury policy. All OID income generated in a MCPT should be recognized by the investors on a complete and timely basis. It is now generally accepted that the amortization of OID in a MCPT involves the same general principles applicable to single class pass-through securities. Furthermore, amortization of OID in a MCPT does not involve insurmountable complexities. While existing IRS regulations do not expressly determine how OID is to be treated in the event of prepayments either for single class or MCPTs, OID recognition will be triggered by prepayments and such prepayments will not cause any income deferrals. We would urge the Committee Staff to work with us to develop one or more alternative methods of calculating OID in such circumstances that meet with Treasury approval.

III NON-MORTGAGE ASSETS

Shearson Lehman Brothers, Inc. believes that MCPTs under the grantor trust rules can be used to securitize such assets as closed-end consumer receivables, commercial-bank loans, commercial real estate mortgages, secured industrial equipment loans, mobile home loans in states that treat them as consumer loans, trade receivables and credit card receivables.

Legislation to allow MCPTs could benefit many of our existing commercial banking, thrift and finance company clients in new and interesting ways. For example, a thrift wishing to enter the commercial loan business could sell investors ownership interests in those commercial loans through a MCPT and generate up front fee income from originating loans, and then remove the loans from its balance sheet, thereby eliminating the risks and the additional capital and reserve requirements that would be created if it funded the loans by incurring additional deposit liabilities. The multiple class structure would reduce the cost of the financing of the origination of such assets and increase revenues to the thrift.

Thus, Shearson Lehman Brothers, Inc. supports inclusion in any MCPT legislation of assets other than residential mortgages.

IV ROLE OF GOVERNMENT SPONSORED AGENCIES

The role of these agencies is to provide supplementary assistance to borrowers by faciliting sales of assets in the so-called "secondary market." It is clear to me that these agencies need the valuable efficiency of the MCPT if they are to be able to continue to provide such assistance. The legislative proposals before the Subcommittee in no way expand the role of these agencies or allow them to move into new markets. They merely increase the efficiency of these agencies in their existing markets. Nor do I believe that the legislative proposals limit conditions for the growth of private sector initiatives. Indeed the role of these agencies has been to encourage participation and innovation in these markets by private sector concens in a spirit of public and private cooperation.

As the former Chief Operating Officer of FHLMC, I can cite you specific examples. In 1971, in cooperation with Wall Street, FHLMC introduced the first conventional mortgage pass-through security. In 1975 FHLMC, in conjunction with FNMA, helped introduce uniform legal documents for conventional mortgages in each state. In 1983, FHLMC sold the first public multiple class mortgage-backed bonds. These innovations assisted private sector concerns in participating in the securities markets. Indeed, that was and still is part of FHLMC's charter act. FNMA has also been innovative in its approach and together with FHLMC has had a salutary effect on mortgage levels and support of affordable housing.

In summary, the most realistic means to achieve meaningful progress toward increased private participation in the secondary markets is to support initiatives developed and supported by the private sector such as MCPTs, yet at the same time, increase the efficiency of agencies such as FHLMC and FNMA without having to augment their charter responsibilities.

CONCLUSION

In conclusion, I feel that the views I have outlined here today reflect a practical view of the needs of the securities industry and its clients that the Congress might find acceptable. Shearson Lehman Brothers, Inc. appreciates the opportunity to appear before the Subcommittee and would be pleased to answer any questions and provide further information as requested.

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Senator CHAFEE. First, is there anybody who believes that the so-called Federal agencies should not be permitted to participate? Raise your hand. [Laughter.]

[Record should indicate that no one raised a hand.]

Senator CHAFEE. I think each of you, in your testimony, said they should be able to participate, as I recall it. Second, are the multiclasses as important for other types of asset-backed securities, other than mortgage-backed securities? Mr. Kasper?

Mr. KASPER. I think they are. We can certainly take those assets and do CMO type structures, as has been done to date, but they are going to be debt obligations. They are going to have the same inefficiencies that CMO's have for mortgages. If we are going to open the market to make CMO's more efficient through this legislation, the power of these other assets really can't be underestimated because these other assets are the best credit that corporate America has in many cases. To pool these receivables to finance their activities this way and accordingly lower their cost of credit and accordingly lower costs which are passed on to users and consumers.

Senator CHAFEE. I know the ingenuity possible in this area is unlimited, I guess, but I was thinking of the automobiles. Who is big in that? Are you, Mr. Fink? Is there any need for multiclasses there?

Mr. FINK. I think one big issue that we have to address is there is a lot of consideration going on right now, undergone by Fasby, for consolidation of all financial subsidiaries. Historically, all automobile companies have been financing automobile receivables and debt through these financial subsidiaries. This is true for at least the companies throughout the United States. If this occurs, which indications are that this will occur, they are going to create some type of forced consolidation of financial subsidiaries, we are going to need a mechanism for sale treatment for these assets.

And I can't think of anything more powerful than that. There are going to be many finance companies that will not be able to access the market properly in a sale form if we do not have treatment that will allow these types of assets to have similar treatments that we worked upon for 15 years in the mortgage market. And if we don't have this type of treatment, we are going to have some problems in these other areas of assets.

It is because of this reason and the 15 years of experience we have had in the mortgage securities market—although we are asking for a compaction in these other assets—but we do have the experience. We are using the same computer models, the same systems, the same care, the same legal work to make sure the safeguards are there.

So, to answer your direct question, yes, I do believe it will cause and create a more fluid and better market.

Senator **Chafee.** Really, I am not sure that was in answer to my question: Should you have the multiple class? Certainly, it should extend to other things. I am not arguing about getting into the automobiles and computers, but I am just wondering what the multiclass is.

Mr. **Fink.** Well, yes, it will save. In the yield curve that we have been experiencing in the last few years, the greatest steepness has been in the front end. The most significant steepness in the yield curve has been in the front end; and as a result of that, yes, we will save financing costs to the consumer. And if that is our ultimate goal, a multiclass or biforcating cat flows in the different components, we will save the American consumer interest.

Senator **Chafee.** All right. Mr. Ranieri?

Mr. **Ranieri.** I agree with Mr. Fink that we would like all assets. I think in terms of the multiclass issue, by definition it is more important when you are dealing with longer assets than shorter assets because you have two issues in the market. One is price and one is availability of funds. The multiclass concept came about originally to insure the availability of funds for 30-year mortgages, as an example. By definition, you have less of that problem on a 4-year asset, such as car loans, than you do on a 30-year asset such as mortgages. Certainly, you don't need multiple classes on a shorter asset to the same degree. In terms of rates, to the extent you have a positive yield curve, you can start cutting things up into days, you know, rather than years to have some effect. I mean, is it pressing? No. Does it have value? Yes.

Senator **Chafee.** My time is up. Senator Long?

Senator **Long.** No questions, Mr. Chairman.

Senator **Chafee.** Do you envision mixing the types of receivables eventually? Do you think you might take these remaining items such as automobile assets or computers and mingle them all together? Mr. Ranieri?

Mr. **Ranieri.** I think, at some point, there will be certain types of receivable assets, as an example, that would be appropriate to comingle where the credit and the structure lend themselves to it.

The whole notion of this market, or one of the notions underlying the market is that very often the sum of the parts—the parts of the chicken are worth more than the whole chicken together—and I think that goes to the heart of a number of these issues.

I can certainly envision at some point, as an example, combining credit card receivables with other types of consumer installment debt in one transaction, as an example. I think you could certainly foresee that.

Senator CHAFEE. In the panel that will be coming after you, the U.S. League of Savings Institutions says that the willingness of Wall Street oriented investors to fund more mortgage securities is more evident in stable or declining interest rate environments. They say that when the rate swings up, there is no assurance these sources will stay in the market. Furthermore, they say that these new MBSs may usurp lending opportunities in declining markets so that portfolio lenders, such as S&Ls, will encounter difficulties in rebuilding their capital bases.

Yet, in a rising market, the portfolio Thrift institution is essential. Now, that is a complicated question. Who would like to take a shot at it?

Mr. FINK. Let me try to take a shot at that first. One has the ability to slice cash flows into different components.

Senator CHAFEE. I can't quite hear you.

Mr. FINK. When one has an opportunity to slice cash flows into different components and into different maturities, in a rising interest rate environment or a declining interest rate environment—and we are seeing volatility even in 1985 of big swings of 100 basis points in a very short period of time—we did not witness, first of all, any decline in investor appetite for this product.

I do believe their intent of the statement was most likely a sharply rising interest rate environment and most likely an interest rate environment where we have an inverted yield curve. And in that case, a multiclass pass through or any type of instrument in which we have different maturity ranges will benefit. The only time when a multiclass pass through has very little benefit in the securities market, be it mortgages or any other assets, is when the yield curve is totally flat. If we have a yield curve that has any slope, be it upwardly sloped or downwardly sloped, we will be able to take advantage of that slope and lower interest rates.

Senator CHAFEE. All right. A brief comment?

Mr. KASPER. Mr. Chairman, I think that comment was only to the effect that Wall Street and the mortgage market have destabilized traditional housing financing; and I think all the efforts and all the evidence is, in fact, just the contrary, that the mortgage market has stabilized the supply and flow of housing credit. By definition, we are not living in a period when thrift deposits are necessary to make mortgage loans. On the contrary, that is why particularly those of us with a Wall Street background who have been doing this for a number of years have direct and meaningful experience. So, if that is the question, we would probably all disagree with that.

Senator CHAFEE. All right. Now, if we pass this legislation, would it reduce the mortgage rates at all? After all, you are already doing this to a considerable extent, so what would this legislation do? I think it would stabilize us and make the situation more acceptable. I suppose more investors would get into the business. Let me just poll each of you.

If we passed this legislation, let's say the legislation I sponsored, what would it do to mortgage interest rates? Mr. Horner?

Mr. **Horner**. We think that it would lower them, at least a quarter of 1 percent, perhaps more.

Senator **Chafee**. Ms. Bernstein?

Ms. **Bernstein**. We think the same, Senator.

Senator **Chafee**. Mr. Fink?

Mr. **Fink**. I would say, in this interest rate environment, maybe a quarter, maybe less; but in an interest rate environment when the yield curve is steeper, either inverted or possibly sloped, it could be as much as 1 percent.

Senator **Chafee**. Mr. Ranieri?

Mr. **Ranieri**. I agree with at least a quarter and, frankly almost as importantly, it would create broad-based competition, which is always helpful.

Senator **Chafee**. Ms. Walker?

Ms. **Walker**. I, of course, agree with Mr. Ranieri. [Laughter.]

We concur.

Senator **Chafee**. Mr. Kasper?

Mr. **Kasper**. I used to have to agree with Mr. Ranieri because I used to work for him, but I don't have to now. [Laughter.]

The answer is we believe that this will significantly lower the cost of credit by making the security more usable by a much wider range of mortgage originators.

Senator **Chafee**. And that inevitably leads to competition?

Mr. **Kasper**. Competition, a broader source of funds, and inevitably the downward pressure on the rate.

Senator **Chafee**. Mr. Rush?

Mr. **Rush**. And if I agree with Mr. Ranieri, I hope you will buy me a lunch. [Laughter.]

I think it is basically a quarter point. You can't really tell in this environment, but it will lower interest rates. The key is getting more investors in the market for that demand. The demand is going to push those rates.

Senator **Chafee**. All right. Mr. Fink, what would you say if we passed the legislation I have but only covered mortgage-backed securities? Would you be for it?

Mr. **Fink**. I think we would be in favor of it, but I think we would be, once again, restricting a level field here; and I would have some reservations, but I think ultimately I would be looking at it. On the mortgage side alone, I would be in favor of it.

Senator **Chafee**. Now, there are going to be some questions that Senator D'Amato will have for you, ladies and gentlemen; and it would be helpful to the whole process if you could answer those rather rapidly. Just send them back to the committee.

Mr. Ranieri, what if anything will this bill or any legislation like it do to narrow the gap between fixed interest rate mortgages and adjustable rate mortgages?

Mr. **Ranieri**. I think we answered that in a sense in that we all feel that this legislation will bring down the cost of fixed rate mortgages. So, to the extent that you are bringing down the cost of fixed rate mortgages, you are narrowing the spread between fixed rate mortgages and floating rate mortgages since this would not tend to have the same kind of an impact on a floating rate mortgage.

So, you would narrow the gap, and it would be good for fixed rate mortgages, make them more affordable, vis-a-vis the floating rate mortgage.

Senator CHAFEE. Do you agree, Mr. Horner?

Mr. HORNER. Yes, I do.

Senator CHAFEE. Thank you. If we fail to pass legislation like this, either mine or Senator Cranston's, how would the mortgage securities market be affected? What is the result? You are out there selling them already.

Mr. RANIERI. I guess I can start it off. I think you have two results. The one I alluded to in my testimony, I think, which is the most troubling to most of us, and that is the problem of arbitrage. We did not invent this technology for a few privileged people to make a lot of money and take most of the benefit, rather than passing it through to the mortgage rate. That problem would go on. You have to again look at the fact that most of CMO's have been arbitrage bonds which dilute the effect of the savings to the homeowner. So, that problem would continue, and the problem of the elite class, in a sense, would also continue, as well as the confusion which is generally occurring as people are trying to find ways to employ the technology while circumventing the tax problem. That is not a healthy situation.

Senator CHAFEE. Mr. Rush, who buys these securities currently? Pension funds? Trusts? Do individuals buy them?

Mr. RUSH. There is a wide range. I would say that probably individuals do not buy them per se. Most of the individuals we see are getting into unit trust type things, to get involved with Ginnie Maes, Fannie Maes, Freddie Macs. It is an institutional approach. I think that certainly thrifts buy them. You have got a number of pension funds buying them, et cetera; but I think that because the multiclass would open up more types of investors, because they could assure themselves of meeting their portfolio requirements with a certain maturity, you are going to see a lot more investors in there.

It is still, I think, predominated by thrifts, but you are seeing more and more pension funds. Insurance companies especially are getting into it now for that return, but it is not across the spectrum.

Senator CHAFEE. Does his experience reflect what most of you have?

Mr. RANIERI. Yes.

Mr. FINK. Yes.

Senator CHAFEE. All right. Fine. Thank you all very much. We appreciate your coming.

Senator Cranston might also have questions for you. So, if you would respond promptly to those also, we would appreciate it.

All right. Would the next panel please come forward? Mr. Lasko, Mr. Wise, Mr. Weber, Mr. Harkins, and Ms. Peters.

If those who are leaving would please do so quietly, we can continue with the hearing. Mr. Lasko, why don't you start?

STATEMENT OF WARREN LASKO, EXECUTIVE VICE PRESIDENT, MORTGAGE BANKERS ASSOCIATION, WASHINGTON, DC

Mr. Lasko. Thank you, Mr. Chairman. Mr. Chairman and Senator Long, my name is Warren Lasko. I am executive vice president of the Mortgage Bankers Association of America. I will keep my remarks brief. I will try to avoid repeating what you have already heard.

We are here today to support strongly both the goals and many of the specific provisions of the two bills you are considering. The future of housing finance is through securitization. That is a fact. Mortgage-backed Securities are a remarkable engine for generating capital for housing and other investments. If well designed, they are safe, standardized security instruments that can efficiently channel large amounts of funds from institutional investors, such as pension funds, and even foreign sources, into local housing markets.

In 1985 alone, over $107 billion in mortgage-backed securities were issued, representing about half of all funds for home mortgage lending during the year. As I say, the future of housing finance is through securitization. The technology of mortgage-backed securities is, in some ways, exquisitely simple; but in other ways, the technology is exceedingly complex. In mortgage-backed securities technology, one obstacle has constantly impeded their complete success, and that is the call protection obstacle. An investor in mortgage-backed securities simply doesn't know the true maturity of the securities because of the wide variety of market events that can affect whether a mortgage prepays in 2 or 3 years or in 10 or 12 years. And this uncertainty imposes a price. The price comes in the form of higher interest rates; and ultimately, the higher interest rates are paid by home buyers.

The so-called collateralized mortgage obligations, or CMOs, go a long way toward helping solve the call protection problem. In fact, over $33 billion in CMO's have been issued by some 30 private firms as well as Freddie Mac in the last 2½ years. But CMO's also have encountered obstacles mainly in the Tax Code. We believe those obstacles were unintended. The grantor Tax Code sections in question were written long before mortgage-backed securities were even thought of. Because of the impediments in the Code, while CMO's are an investor's dream come true, they are an accountant's nightmare.

Furthermore, very recently the marketplace is finding ways around the Tax Code obstacles through use of REIT's and so-called owner's trusts, but these are expensive and highly inefficient solutions when a reasonably simple solution lies in sight. Let me briefly emphasize the specific reasons for our support for the thrust of these bills.

First, they eliminate a tax regulation hurdle thrown up by proposed Treasury Department regulations. These require most multiclass securities to be treated as debt of the issuer, rather than as a sale of assets. Most lenders—and here I am speaking for our own members in particular—simply can't withstand the balance sheet impact of the debt approach. And we believe they shouldn't have to.

Second, the bills clarify the tax treatment of multiclass securities. This is a rare occasion indeed where private firms are pleading for guidance on how much tax to pay. There are already $33 billion in multiclass securities outstanding where issuers and investors alike have little guidance on their tax liability. Third, the bills will allow investors to treat multiclass securities as eligible investments and mortgage instruments to satisfy regulatory requirements, just as other forms of mortgage-backed securities already do. We believe these bills are fully consistent with existing policy established by Congress and contained in the National Housing Act to increase the efficiency and liquidity of the secondary mortgage market. The bills in our view do not change policy; they simply remove unintended obstacles to the free and efficient flow of credit, particularly to the Nation's home buyers.

We are not expressing a preference at this time for one or the other bill. We do—and I will just do this quickly—indicate that whichever course is pursued, and we would imagine a combined course would be pursued, that residential and commercial mortgages both be included in the allowable collateral, that Fannie Mae and Freddie Mac be accorded full participation in the transactions, and that Ginnie Mae securities be eligible as underlying collateral for the transactions.

In conclusion, let me say, by removing unintended obstacles to the efficiency of the capital market, it will create a smoother, less costly flow of credit to housing. The ultimate gainers at no cost to the Government will be today's and future generations of American home buyers.

Thank you very much.

Senator CHAFEE. And thank you very much, Mr. Lasko.

Mr. Wise?

[The prepared statement of Mr. Lasko follows:]

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202-861-6500

Mortgage Bankers Association of America

STATEMENT OF

WARREN LASKO
EXECUTIVE VICE PRESIDENT

of the

MORTGAGE BANKERS ASSOCIATION OF AMERICA

before the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

of the

COMMITTEE ON FINANCE
UNITED STATES SENATE

Hearings on

S 1959, "The Secondary Market Tax Amendments of 1986," and
S 1978, "The Recovery Act for Mortgage and Other Asset-Backed Securities"

January 31, 1986

Mr. Chairman and members of the Subcommittee, my name is Warren Lasko. I am Executive Vice President of the Mortgage Bankers Association of America.* Accompanying me are Burton C. Wood, MBA's Legislative Counsel, and Brian D. Cooney, MBA's Associate Legislative Counsel.

We appreciate the opportunity to appear before you today to discuss the recently introduced bills, S 1959, "The Secondary Market Tax Amendments of 1986" (SECTA), and S 1978, "The Recovery Act for Mortgage and Other Asset-Backed Securities" (RAMBO). MBA strongly supports the concepts embraced in these legislative proposals because they attempt to clarify the tax treatment of multiple class mortgage-backed securities (MBSs) through amendments to the Internal Revenue Code (Code). The outstanding taxation problems pertaining to these securities threaten to limit the growth and efficiency of the secondary mortgage market and to inhibit the new developments taking place in the capital markets.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

MBA headquarters is located at 1125 15th Street, N.W., Washington, D.C. 20005; telephone: (202) 861-6500.

BACKGROUND

Both bills attempt to eliminate the uncertainty with respect to the taxation of multiple class securities through amendments to the Code. A fundamental feature of any successful MBS is the imposition of tax liability on the investor, rather than on the issuer, arising from mortgage payments. Under current law, attempts to accomplish this have been made in two general ways.

First, a pass-through instrument has been used where the mortgages are legally owned by the trustee of a grantor trust and beneficially owned by the investors. Cash payments on the underlying mortgages, as well as all tax consequences, are "passed through" to the investors as beneficiaries of the trust. This is an attractive mechanism for the issuance of multiple class securities because the sale of the mortgages to a trust allows issuers to utilize the sale of assets accounting treatement on their balance sheets. This is the preferable method of booking this type of transaction, as opposed to recording it as debt, because it assists lenders without deep capital bases by not creating an additional liability on their balance sheets.

The second way that has been tried is to create a taxable entity that issues collateralized mortgage obligations (CMOs). In this case, the bond issuer recognizes income arising from its ownership of the mortgages and deducts interest on the obligation issued to the bondholders, who in turn report the interest as income on their tax returns. The problem with this mechanism is that the issuer retains ownership of the mortgages and must record the security as a debt obligation on its balance sheet, which requires heavy capitalization.

These developments have revealed uncertainties and ambiguities in the application of the Code to MBSs. How to classify a given structure as either a passthrough or as a CMO is essential for tax consequences, but unclear under current laws. Some of the problems involve the treatment of original issue discount (OID) and the type of assets includable in underlying collateral.

On May 2, 1984, the Treasury Department proposed restrictive amendments to its regulations with respect to the classificiation of investment arrangements with multiple classes of ownership, including mortgage-backed pass-through securities. The proposed amendments relate to the definition of the term "corporation," including "associations" taxed as corporations under Section 7701 (a) (3) of the Code, and to the definitions of the terms "trust" and "fixed investment trust" under Section 301.7701-4 of the regulations promulgated under the Code. The proposed amendments were designed to clarify the meaning of the term "fixed investment trust" and the application of the regulations to grantor trusts with multiple classes of ownership.

As a result of these amendments, a grantor trust qualifying for pass-through treatment must provide terms of investment that are essentially fixed when the trust is created. Thus, mortgages generally cannot be bought and sold or replaced (due to defective collateral, prepayments or otherwise) without losing the benefits of pass-through treatment. Nor can the instruments be tiered for different payment expectations, unless the securities are overcollateralized, as is currently done with CMOs. If a trust provides for such powers of "active," as opposed to "passive," management, it will be characterized as an association taxable as a corporation. The resulting imposition of a "phantom" income tax on the issuer, in addition to the investor level income tax, in most instances more than offsets the financial advantages of pooling mortgages into a multiple class investment instrument.

The uncertainty of tax treatment spawned from the ambiguity of the current tax Code increases yields paid by issuers for multiple class MBS offerings in terms of the legal fees for opinions of counsel and other transaction costs. The uncertainty of prepayment for standard MBSs also adds to the yields issuers must pay in order to attract investors. The fact that CMOs must currently be overcollateralized to set up specified payment expectations within the tranches, or classes, reduces the efficiency of those securities. This higher cost of funds is passed on to homebuyers in the form of higher interest rates. It is the intention of the SECTA and RAMBO proposals to provide certainty to the tax treatment of these transactions and thus lower issuers' expenses in "going to market."

This is not the first time legislation pertaining to multiple class securities has been introduced and debated in Congress. The Trusts for Investment in Mortgages (TIMs) legislation, which ultimately died without passage at the close of the 98th Congress, was the subject of hearings in 1983 before the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing and Urban Affairs and the Senate Finance Committee. In addition, hearings were held in 1984 before the Subcommittee on Housing and Community Development of the Committee on Banking, Finance, and Urban Affairs of the U.S. House of Representatives. Members of MBA appeared and testified at both sets of hearings in general support of the TIMs proposal.

CURRENT LEGISLATIVE PROPOSALS

In our analysis of the SECTA and RAMBO proposals, MBA finds there are several provisions in both proposals which we favor. Both proposals are desirable in that they would increase the supply of funds for housing at lower interest rates. MBA strongly supports the concepts behind both bills and specifically supports the inclusion of the following provisions in any legislation enacted with respect to multiple class securities:

-The allowance of multiple classes of ownership, or tranches, that provide call protection to investors that have differing timing needs in structuring their investments.

-The issuance of the multiple class security would be recorded as a sale of assets on the financial statements of the issuer. For Federal income tax purposes, the income derived from the underlying collateral would be passed through to the investors of the securities, who would have beneficial ownership of such collateral.

-The clarification of the OID rules in order to provide certainty as to the proper taxation of prepaid mortgage loans and to assign tax liability only to those parties receiving economic benefit from the underlying collateral. This would eliminate the imposition of a phantom income tax at the entity level and be particularly helpful in situations where the collateral is mostly comprised of seasoned loans that bear less than current market rates of interest.

-The allowance of residential and commercial mortgage loans to be included in the underlying pool of assets collateralizing the securities.

-The allowance of the full participation of the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), both as issuers and in allowing their MBSs to be used as collateral in the underlying pools. (See discussion below for further information on this issue.)

-The inclusion of Government National Mortgage Association (GNMA) MBSs as underlying collateral.

-The allowance of institutional investors to count the multiple class securities toward meeting regulatory and other requirements that pertain to investment volume in mortgage-related instruments.

-The elimination of any requirement for overcollateralization of underlying assets as required in CMOs as this reduces the efficiency of multiple class offerings.

-The assurance of revenue neutrality. Rules should be designed to ensure that the amount, timing, and character of income realized by the investors is not reduced, slowed down, or otherwise modified so as to be adverse to the revenue of the Treasury. The certainty of tax treatment provided by amendments to the Code may create some revenue gains resulting from increased taxpayer compliance. This would help alleviate the concerns Treasury had in opposing the previously introduced TIMs legislation.

MBA strongly supports the inclusion of both residential and commercial mortgage loans in the underlying pool of assets collateralizing these securities. We believe the inclusion of real estate related assets will lower interest rates on all mortgage loans and help to provide fair and decent housing for all Americans. MBA has no policy position with respect to the inclusion of other assets as collateral in the underlying pools securing multiple class pass-through securities.

There are certain differences in approach found in the SECTA and RAMBO proposals which do merit specific mention. Specifically, these issues deal with the degree of complexity of the proposed tax law amendments found in the two bills, the instruments that can be structured into multiple classes, and the scope and breadth of the underlying assets that may be included as collateral securing multiple class securities.

With respect to the complexity of the tax law amendments, the RAMBO approach provides a much less complicated alternative to the SECTA approach in that it simply overrides Treasury's proposed draft regulations relating to the grantor trust rules. It does not offer amendments to the OID rules and would presumably leave Treasury with the task of devising such amendments. On the other hand, the SECTA bill provides exhaustive amendments to the OID rules in order to clarify their application to multiple class securities.

In addition, the SECTA bill creates a new multiple class instrument known as a collateralized mortgage security. The creation of a new security is oftentimes accompanied by a new set of rules relating to accounting and tax matters that are specifically designed to apply to that security (e.g., real estate investment trusts, real estate limited partnership interests). RAMBO would allow MBS instruments issued after April 27, 1984 (the effective date of the proposed Treasury regulations) to be structured in multiple class pass-throughs.

Regarding the question of what assets should be eligible for inclusion in the collateral underlying the multiple class securities, the two bills differ substantially. The tax amendments under the SECTA bill would apply only to residential mortgage loans and other mortgage-related assets, while the amendments to the grantor trust rules under the RAMBO bill would apply to a much broader asset category, including residential and commercial mortgage loans, automobile loans, and credit card and lease receivables.

Proponents of the narrower approach would point out that because there is much more data and a better understanding of how mortgages and MBSs behave than there is of other asset-based securities, tax amendments relating to multiple class securities should be limited to mortgage loans only. In addition, some of the advantages in allowing a broader category of assets to collateralize these securities would not be experienced until the investment laws under which institutional investors operate are amended to allow these participants to invest in such a broad array of assets. This includes both public and private pension funds.

On the other hand, one of the considerations involved in supporting the broader RAMBO approach is that the inclusion of other assets would respond to recent Congressional concerns relating to high interest rates on credit cards and other consumer loans. Companies making these loans will be able to finance these assets at substantially lower costs and pass on the savings to consumers in the form of lower interest rates.

Another result of broadened asset coverage would be that commercial banks would be able economically to securitize and sell student loans, automobile loans, commercial real estate loans, and other loans to investors. In light of their existing portfolios of troubled loans in the areas of agriculture, energy, and Third World debt, this could add liquidity and new sources of revenue to their overall financial condition and alleviate the concerns of bank regulators and stockholders. Also, thrift institutions that have diversified into non-residential areas of lending by virtue of recent powers granted to them by the Garn-St Germain Act will be able to mitigate loan losses resulting therefrom through the securitization and sale of those loans in the form of multiple class securities.

In addition, prominent financial commentators have been warning that the health of American corporations is endangered because many carry excessive debt burdens. The sale of assets accounting treatment applicable to a broad range of asset-backed multiple class securities would aid those financial institutions whose balance sheets are over-leveraged.

Since 1970, when GNMA MBSs were first issued, over ~~$267~~ 453 billion in MBSs have been issued. In 1985 alone, over ~~$46~~ 157 billion were issued, representing an estimated ~~20~~ 50 percent of all funds for home mortgages during the year. However, the currently ambiguous and uncertain set of tax rules under which the secondary mortgage market operates has inhibited its continued growth and evolution. Because the issuance of pure multiple class pass-through securities has effectively been prohibited by the proposed Treasury regulations, investors in this marketplace demand higher yields on standard MBSs due to their lack of call protection. If investors could be assured of certain and orderly payments on their investments, they would be willing to accept lower yields. These savings, together with lower transaction costs, would be passed on to homebuyers in the form of lower interest rates.

This lack of call protection has caused certain large institutional investors that seek long term investments, such as pension funds and life insurance companies, to shy away from standard MBSs. This is particularly noteworthy in light of the fact that the Employee Retirement Income Security Act (ERISA) had been amended prior to 1983 in order to make it easier for private pension funds to invest in MBSs.

With the development of CMOs, pension funds have increased their overall investment in mortgage-related assets. In particular, a great majority of their CMO investments have been in the intermediate and longer term tranches. The value enhancement provided by the CMO structure is especially important to pension funds and insurance companies, therefore making investments in mortgage-related securities an attractive option. According to data compiled by the Economics Department of MBA, approximately 90 percent of the intermediate and long (7- and 20-year) CMO tranches issued during 1984 were purchased by pension funds and insurance companies. In comparison, these investors accounted for only 17 percent of the standard agency-related (GNMA, FNMA, and

FHLMC) MBS purchases during the same time period. This is particularly significant in light of the fact that 75 percent of the collateral of CMOs issued during 1984 were agency-related.

Certain provisions found in HR 3838, the "Tax Reform Act of 1985," currently being considered by the Finance Committee, may, if enacted into law, inhibit the continued growth of the CMO market. Because homebuilders may currently utilize installment sales tax treatment in tandem with their CMO issuances, they can enhance the after-tax yields by deferring tax liabilities. HR 3838, however, would preclude the use of installment sales tax treatment for these debt offerings, and as a result, many small builders who have relied on the installment sales tax treatment may be forced out of the CMO market. The multiple class pass-through securities envisioned by the SECTA and RAMBO proposals would not be affected by this change because of their non-debt nature. If market interest in CMO instruments wanes as a result of these tax reform amendments, multiple class MBSs could fill the void and benefit all market participants, including homebuyers, issuers and investors.

PARTICIPATION BY FNMA AND FHLMC

When the TIMs legislation was being considered during the 98th Congress, the current Administration opposed the participation of FNMA and FHLMC primarily because it was felt that their presence would overwhelm that of private issuers. While there was a substantial market preference due to the government backing for their MBSs when those instruments were at an experimental stage in the 1970s, this is simply not the situation today.

The investment market is well-acquainted with MBS issues, as these products have been tested and accepted by a wide variety of investors. Furthermore, unlike the private companies seeking to compete for conventional MBS markets, FNMA and FHLMC still must fulfill their mandated public purpose goals. The presence of FNMA and FHLMC has not impeded the advance of private entites into the secondary market arena and their full participation, both as issuers of multiple class securities and by permitting their MBSs to be used as underlying collateral, should not be excluded from the markets they have worked diligently to develop.

Primarily, the issue boils down to one of timing. With the presence today of such a high level of demand, it appears to us that now is the time to encourage more participants to the mortgage marketplace, rather than the time to engage in an experiment to test the ability of private entities to replace government-related entities in vital new markets.

The tremendous prospective demand for residential mortgage credit in this country has drawn the attention of many financial and industrial giants in recent years. Indeed, quite a few have already begun to establish market presences. It is MBA's belief that lower interest rates, more than any other factor, are the key to spurring additional private entrants into the marketplace. So long as mortgage rates are affordable and demand is present, as in the current economic cycle, the market will support competition among a large number of secondary market operators because volume is the key to success in those markets. The inclusion of the widest variety of players in all mortgage markets will best serve the needs of consumers, who could choose from the widest variety of competitively priced products.

MBA believes that the full participation of FNMA and FHLMC in multiple class securities transactions would serve to expand the development of the secondary mortgage market, rather than inhibit private entries. The passage of these initiatives will introduce a new era in mortgage finance, similar to the early 1970s. The federally sponsored instrumentalities will serve as a catalyst to these developing markets, as their presence would provide the standardization and volume that is necessary for multiple class MBSs to attract substantial investor interest. Those two factors are necessary to ensure that the products offered will be liquid and marketable.

Furthermore, the full participation of FNMA and FHLMC in all geographic markets and during all economic cycles will add much-needed stability to the marketplace and, thus, will serve as a continuing presence that investors may use as a benchmark against which to judge privately backed issuances. This stability will still allow experimental and custom-tailored multiple class securities to be marketed successfully. But the market will be able to judge offerings against a standardized version.

During the initial development of conventional MBS issuances (and also ARMs and other alternative mortgage forms in the primary mortgage markets), FNMA and FHLMC played a crucial role in standardizing those instruments. Furthermore, marketability is often tied to the concept of a standardized, accepted instrument. For example, ERISA places a great deal of emphasis upon market acceptance and ties that concept to government-related securities. The stabilizing presence of FNMA and FHLMC in the multiple class securities market would underscore the acceptability of the instruments. The importance of standardization is that investors are most attracted to instruments that have large, liquid markets, so that the value of such a holding can be readily determined, and so that the instruments may be readily bought and sold. Inclusion of FNMA and FHLMC in multiple class securities legislation will ensure the creation of a large, liquid market fairly quickly. That will benefit all participants—homebuyers, lenders, issuers, and investors.

CONCLUSION

MBA strongly supports legislative proposals that would amend the tax laws to permit the issuance of multiple class pass-through MBSs in order to remove tax liability at the issuer level. Such amendments would offer investors call protection and would thus lessen the unpredictability of prepayments. Homebuyers would realize a benefit in terms of lower interest rates that would result from more favorable secondary market pricing.

MBA strongly supports the full participation of FNMA and FHLMC in these transactions. In addition to the authority of those government-related agencies to issue multiple class pass-through securities, MBA also supports the inclusion of their securities, together with GNMA's securities, as eligible collateral that could be used to secure multiple class securities issuances.

MBA appreciates the opportunity to testify and would be pleased to furnish additional information, if needed.

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STATEMENT OF MICHAEL WISE, CHAIRMAN OF THE BOARD, SILVERADO BANKING OF DENVER, CO, ON BEHALF OF THE U.S. LEAGUE OF SAVINGS INSTITUTIONS

Mr. WISE. Mr. Chairman, my name is Michael R. Wise; I am chairman of the board and chief executive officer of Silverado Banking, a savings institution headquartered in Denver, CO. I appear today on behalf of the U.S. League of Savings Institutions where I serve as chairman of its Regulatory Policy Committee, a member of its legislative committee, and have participated in the work of the league's task force on mortgage-backed securities.

Traditionally, our member institutions have been portfolio lenders, originating and holding mortgages to maturity. However, today our industry is in transition. A growing segment of our institutions invest heavily in the securities under discussion today. Thus, savings institutions have a major stake in the securitization process since the member thrift institutions of the U.S. league provide the bulk of this Nation's private sector credit for home mortgages. We are well aware of the technical tax problems which these bills address, but the Tax Code revisions suggested do raise other nontechnical policy issues.

The league has several reservations about streamlining Tax Code provisions to facilitate mortgage origination for packaging and marketing through mortgage-backed securities.

First, is the legislation pending before the subcommittee indeed revenue neutral—an issue raised by the Treasury this morning. Could overreliance on Wall Street credit sources through security investment destabilize mortgage finance throughout the interest rate cycle? Will new innovations be an invitation to mortgage securitization also invite substandard underwriting and encourage haphazard housing activity, with resulting damage to all elements of housing finance? Will these proposed statutory changes enable federally sponsored secondary market agencies to magnify further their dominance of secondary market activity in conflict with objectives expressed by the administration?

And finally, is the broad scope of these bills required in light of innovative changes which comply with existing tax law and are already overcoming the financial statement problems presented by CMO's?

Frankly, we feel that a major thrust of any tax law changes in mortgage securitization should focus on the problems which portfolio lenders face in liquefying their portfolio of low coupon mortgages. These loans are the type of collateral which produce the greatest problems in applying the existing original issue discount rules.

It is important to remember that despite the valuable supplementary funds provided by the nontraditional mortgage investors, the bulk of mortgage finance continues to flow through our institutions. Thus, the league supports, as a stand-alone item, the clarification found in S. 1959 to DEFRA's application of original issue discount tax principles to securities backed by below market mortgages, the so-called phantom income problem. The league also asks consideration of an amendment to qualifying assets list found in Internal Revenue Code, section 7701(a)L9(c), which determines eligibility for the thrift bad debt method of section 593 to include investment in private collateralized mortgage obligations. Senate bill 1959 does make this change in the qualifying asset list.

S. 1978 as proposed is less useful to thrift institutions since it fails to address the CMO phantom income problem and is designed to facilitate securitization of mortgages that are treated as having been sold while the mortgage securities of greatest use for thrift institutions involve borrowings.

We appreciate the opportunity to summarize our views for you this morning. We would urge you to bear our overall reservations in mind as you proceed with your deliberations on these subjects. And we will be happy, if you should decide to proceed, to work with your staff in pursuing that goal. Thank you very much.

Senator **Chafee**. Thank you very much, Mr. Wise. You represent a very substantial part of the industries that fund home building, and so therefore, we are grateful for your views.

Mr. **Wise**. Thank you, Mr. Chairman.

Senator **Chafee**. Mr. Weber.

[The prepared statement of Mr. Wise follows:]

Statement of Michael R. Wise
On behalf of the U.S. League of Savings Institutions
To the Subcommittee on Taxation and Debt Management
Senate Committee on Finance
January 31, 1986

MR. CHAIRMAN:

My name is Michael R. Wise. I am Chairman of the Board of Silverado Banking, a savings institution headquartered in Denver, Colorado. I appear today on behalf of the United States League of Savings Institutions, where I serve as a member of the Legislative Committee and have participated in the work of the Task Force on Mortgage-Backed Securities.

I appreciate this opportunity to present the views of the League and its 3,400 savings and loan and savings bank members on your bill S.1959, Mr. Chairman, "The Secondary Market Tax Amendments of 1986", and S.1978, by Sen. Cranston and others, "The Recovery Act for Mortgages and Other Asset-Backed Securities". Both bills are designed to resolve pending questions regarding the application of tax law principles to the complex financing arrangements found with pass-through securities.

While these tax technicalities are of concern to the investment banking community, these legislative initiatives raise anew fundamental questions about the wisdom of increasing our reliance on the capital markets to meet the demand for home mortgage finance, by far the largest segment of our nation's private-sector credit requirements. For many years, the depository thrift institutions represented by the U.S. League, have supplied the bulk of the funds needed by the American people for home ownership.

Before embracing these legislative proposals, the Congress should examine critically such matters as: the potential revenue impact of these tax code alterations; the reliability of these credit sources in all phases of the housing and interest-rate cycles; the supervision of the mortgage and other originators providing the assets to be securitized and the supervision of the conduits involved in the process; the protections available to securities investors; and whether the bills address tax compliance problems with securities already being marketed or merely anticipate regulations yet to be issued by the Internal Revenue Service.

These hearings, of course, occur as the Senate approaches the difficult task of comprehensive tax code overhaul for "fairness, simplicity, and growth", as recommended by the Administration. Whatever may be said of their purposes and merits, S.1959 and S.1978 do not, on their face, contribute to tax code simplification.

This is not the first time that the Congress has been asked to facilitate mortgage securitization through amendment to the Internal Revenue Code. In the last Congress, a proposal for "Trusts for Investments in Mortgages", or TIMs, was advanced. Like TIMs, the Collateralized Mortgage Security (CMS) authorized by S.1959, and the revision in the treatment of grantor trusts advocated by the sponsors of S.1978, seek to assure the non-taxability of the middleman or conduit through which timely payments from mortgagors (or other debtors) are passed to various classes of securities' holders.

General Reservations about S. 1959 and S. 1978

We are skeptical concerning representations that there is no revenue impact from this streamlined tax process -- particularly to the extent that these trust mechanisms displace traditional intermediaries, such as savings institutions, which are significant corporate taxpayers. In this period of national concern about the federal deficit, we strongly urge the Subcommittee to seek revenue impact estimates for these proposals to confirm whether indeed they are revenue neutral.

Secondly, unlike specialized institutions such as thrift institutions which originate and retain a portfolio of home mortgage loans, we question whether an over-reliance on mortgage securities could destabilize the availability of mortgage finance throughout the interest rate cycles. The willingness of Wall Street-oriented investors to fund mortgage securities is most evident in stable or declining interest-rate environments. When rates swing back up, there is no assurance these sources will remain in the mortgage market. By contrast, to the degree mortgages originated for mortgage-securitization purposes usurp lending opportunities in declining markets, portfolio lenders will encounter difficulties in rebuilding their capital bases. Yet in a rising market, the continued performance of the portfolio thrift -- with its repayment flows -- is essential if a semblance of normal homebuying activity is to be maintained.

We are also concerned that new invitations to mortgage securitization may invite shoddy underwriting of loans packaged and sold to investors or encourage haphazard housing activity. The recent EPIC problem, the problems with REITs a decade ago, and the abusive practices by unregistered issuers and dealers in the marketplace for Ginnie Mae pass-through securities in the late '70s, bear witness to this concern. Vice Chairman Preston Martin of the Board of Governors of the Federal Reserve System articulated similar reservations in testimony before the Senate Banking Committee in September, 1983:

> "One thing missing (in S.1822, the TIMs proposal), however, is reference either to quality standards for the "TIM" securities or to supervision of the trustees or managers of TIMs . . . I am concerned that creation of new types of mortgage investment trusts, that apparently could take a variety of forms (corporate or otherwise) under S.1822, and that would permit trustees to actively manage the funds entrusted to them by individual investors, would create leeway for bad reinvestment decisions or even for abusive practices by trustees or managers. Such events, of course, could heavily damage all elements of the private mortgage pass-through securities market.
>
> It's difficult to specify at this time the type of supervisory structure within which TIMs ideally should operate. One possibility would be to require TIMs be subject to the types of controls established for mutual funds registered under the Investment Company Act of 1940 -- other entities with flow-through tax treatment under the Internal Revenue Code."

Yet another issue of apparent concern to the Administration is the expanding participation of the federally-sponsored housing credit agencies in mortgage securities. To the degree that S.1959 and S.1978 magnify the already dominant position of FNMA, FHLMC and GNMA in mortgage securitization, these legislative proposals will aggravate anticipated efforts to diminish their competition with the private sector.

Finally, on several counts, there is a question of the "need" to expedite mortgage securitization through these tax code changes.

Traditional sources for mortgage credit, especially thrift institutions, are fulfilling mortgage demand. In 1985, savings institutions provided $191 billion in home loans. Mortgage rates are their lowest in several years and, according to a recent Home Buyer's survey by the U.S. League, homes are increasingly affordable. Families who spent more than one-quarter of their monthly income on housing costs -- mortgage principal and interest, real estate taxes, utilities, and homeowner's insurance -- dropped from 40.4% in 1983 to 33.5% last year, the lowest figure since the study series began in 1977.

In addition, several innovations in mortgage securitization have already overcome perceived roadblocks to the process. The most important of these was the development of Collateralized Mortgage Obligations in 1983, which provided for multiple classes of securities attractive to a variety of investors including other thrifts and banks, insurance companies and pension funds. CMOs, when utilized by thrift institutions, increase the value of their mortgages collateralizing a securities issue in two ways. First they enable a thrift institution to attract short-term investors who, because they are assured of recovering mortgage principal in 3 to 5 years, are willing to accept a yield lower than they would if they bought a mortgage loan outright. (This is known as the fast-pay portion of a CMO.) Meanwhile, holders of the "slow pay" or longer bonds in the multi-class CMO, receive substantial "call protection" -- one of the traditional drawbacks to mortgage investment because of the irregular prepayment patterns of home loans -- since payments of principal will not be received until prior classes of investors have been paid in full.

Some of the more recent CMOs have been particularly useful to thrift institutions since the enhanced value of the securities structure enables participating institutions to monetize, or put to work, below-market loans held in portfolio. Your bill, S.1959, Mr. Chairman does clarify present tax uncertainties with these instruments. The mismatch between the cost of attracting savings and large portfolios of fixed-rate, below-market loans created the thrift crisis early in this decade when interest rates soared. It is essential that thrift institutions utilize a variety of restructuring tools to avoid a recurrence of that exposure in the future. The popularity of the adjustable-rate mortgage is making a major contribution to the restructuring goal, along with limited new investment powers adopted by the Congress in the Garn-St Germain Act of 1982. Prudent use of CMOs, such as Capital Access, a joint venture between the U.S. League and Salomon Bros., can also reduce portfolio interest-rate risk and enhance portfolio yield. (A schematic of the Capital Access plan appears as Exhibit A.)

Just as the CMO's arrival accomplished a major objective of the TIMs proposal , the serial redistribution of mortgage principal to a variety of investor classes -- thus making a legislated solution unnecessary -- it now appears that yet another new development may solve a pending problem. As we understand it, a major motivation for both S.1959 and S.1978 is to overcome an IRS ruling which threatened taxation of a multiple class security utilizing a grantor trust involving the sale of assets as a corporation. The mechanism was designed by Sears-Dean Witter in an attempt to avoid adding debt to the issuer's books. This perceived problem may already be solved according to a recent edition of The Bond Buyer, attached as Exhibit B. The use of a new "Owner's Trust" technique enables the issuer to avoid the adverse financial statement and accounting consequences of the earlier types of securities issues in this asset sale format.

In short, there are several reasons why Congress should proceed cautiously before embracing wholesale statutory changes to expedite the mortgage securitization process.

I would now like to proceed to some more specific observations about the legislative drafts before the Subcommittee today.

Secondary Market Tax Amendments (S.1959)

If the Subcommittee and the Congress do choose to pursue these proposals, the most helpful suggestion from the viewpoint of the thrift industry is the clarification found in S.1959 of the application of original issue discount (OID) principles to securities backed by below-market mortgages -- the so-called "phantom income" problem. The Deficit Reduction Tax Act of 1984 (DEFRA) extended the OID apparatus to mortgage finance. This complex accrual structure is essentially designed for corporate bonds which typically pay interest only with a "bullet" return of principal at maturity. Extension to amortizing instruments such as the straightforward fixed payment residential loan is not a simple task. Even in the primary market, treatment of financed points at the loan origination remains unclear under present law and we await Treasury regulations on this topic. "Phantom income" can arise at the conduit or trust level because of the disparity in discounts between the mortgages collateralizing a CMO issue and the variety of discounts on the several classes of security into which the collateral pool is divided. Exhibit C, from Secondary Mortgage Markets magazine, a journal published by the Federal Home Loan Mortgage Corporation, illustrates this problem, which certainly deserves statutory clarification for the current and ongoing CMO market.

S.1959 also provides that investments in the newly-authorized collateralized mortgage security are treated as eligible investments for thrift institutions since security holders are treated as owners of undivided interests in "qualified obligations" (defined to include interests in real property). This provision highlights an existing problem for institutional thrift investors in private-sector mortgage securities that are not obligations of the federally-connected secondary market agencies. Such purely-private mortgage securities are presently ineligible as investments to meet the qualifying assets test for thrifts utilizing Section 593 of the Internal Revenue Code. (The ability of savings institutions to allocate 5% of their taxable income to bad debt reserves under Section 593 is preserved in H.R. 3838 passed in December by the House of Representatives.) Since investments in CMOs and those CMS which are mortgage-backed are the functional equivalents of the direct mortgage investments, we urge this Subcommittee to consider a broader categorical change to the investments appearing in Section 7701(a)(19)(C) of the Code, the definitional section for thrift institution taxpayers utilizing Section 593.

As a further, technical comment, we wonder why the definition of "qualified obligation" appearing in Sec. 1290(e)(2) appears to permit further repackaging of all portions of a CMS, including the so-called Z-portion. Similarly, any "guaranteed investment contract", is included as a "qualified obligation" and apparently substitution of such GICs can occur at any time, unlike the other collateral listed in the definition. We do not understand the purpose of this portion of the definition.

We also have difficulty reconciling the statutory language presented in Section 1291(b)(2), regarding non-recognition of losses upon transfer of property to the CMS pool in exchange for cash, with the Technical Explanation provided.

Recovery Act for Mortgages and Other Asset-Backed Securities

Our major disappointment with S.1978 is its failure to address the acknowledged tax law question arising from the application of original issue discount principles to mortgage finance under DEFRA -- the "phantom income" arising in CMOs backed by discounted mortgages. The bill underscores this position by defining pass-through securities to represent interests in assets that are treated as having been sold. The CMOs of greatest utility to thrift institutions -- those which enable portfolio restructuring by putting below-market loans in portfolio "to work" -- involve borrowings for accounting and tax purposes rather than sales of loans.

However, if the Congress sees fit to provide a tax exemption to multi-class pass-through securities trusts, and not tax them as corporations (as proposed by the Treasury regulations of May, 1984), we concur that there is no reason to restrict this greatly-expanded tax-free securitization scheme to mortgage finance. As Senator Cranston comments in his statement upon introduction of the bill, "It would be incongruent to divide the capital markets by permitting one form of assets, mortgages, to be securitized versus other types of assets." While we see the force of Senator Cranston's argument on this point, given the omission of a correction of the phantom income problem with CMO-liability issues, we feel that this observation could be coupled with the otherwise preferable features of S. 1959.

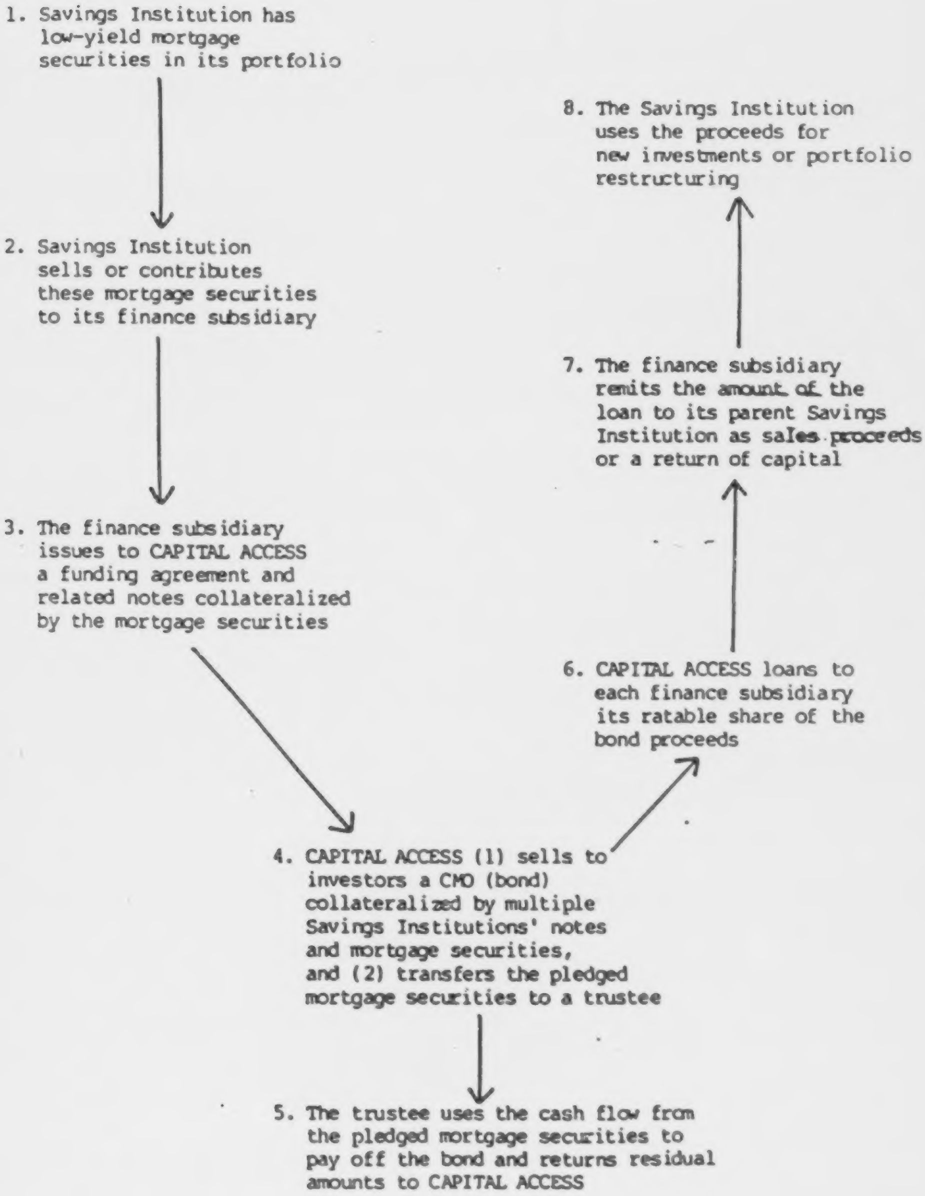
As a final technical point, there appears to be an inconsistency between that portion of the definition of "financial instrument" in S. 1978 which includes any property acquired due to default (Sec.680(d)(3)(C)) and the exception appearing in the second proviso of the general rule (Sec.680(a)(2)), where substitution of property is only permitted where a breach of warranty occurs.

The U.S. League has appreciated this opportunity to present its general observations about the need for additional tax legislation regarding mortgage securitization and that of other assets, and more specific comments about the contents of S.1959 and S.1978, as introduced. We would be pleased to offer our staff resources as the Subcommittee pursues these subjects. I look forward to your questions.

# # # # # # #

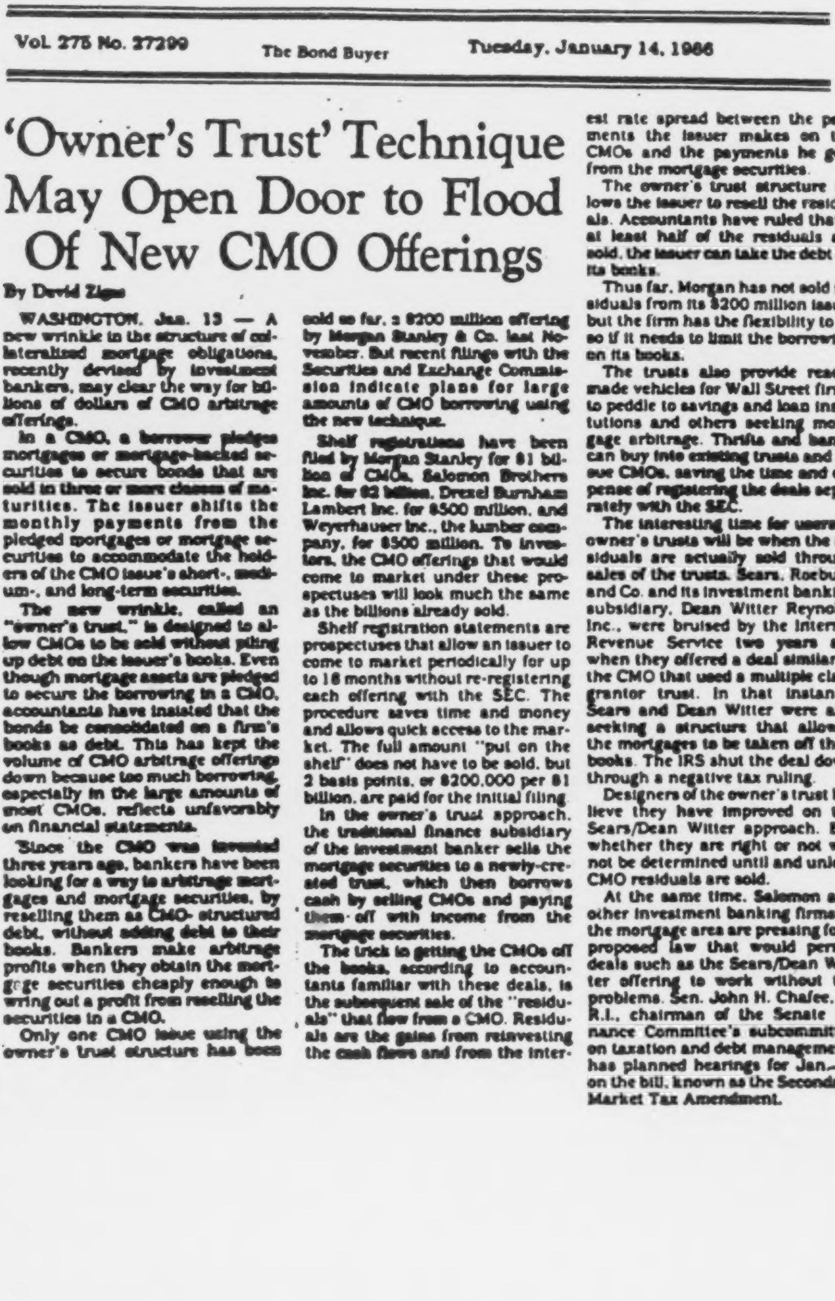
EXHIBIT A

CAPITAL ACCESS
FOR
SAVINGS INSTITUTIONS



1. Savings Institution has low-yield mortgage securities in its portfolio
2. Savings Institution sells or contributes these mortgage securities to its finance subsidiary
3. The finance subsidiary issues to CAPITAL ACCESS a funding agreement and related notes collateralized by the mortgage securities
4. CAPITAL ACCESS (1) sells to investors a CMO (bond) collateralized by multiple Savings Institutions' notes and mortgage securities, and (2) transfers the pledged mortgage securities to a trustee
5. The trustee uses the cash flow from the pledged mortgage securities to pay off the bond and returns residual amounts to CAPITAL ACCESS
6. CAPITAL ACCESS loans to each finance subsidiary its ratable share of the bond proceeds
7. The finance subsidiary remits the amount of the loan to its parent Savings Institution as sales proceeds or a return of capital
8. The Savings Institution uses the proceeds for new investments or portfolio restructuring

EXHIBIT B



Vol. 275 No. 27299 The Bond Buyer Tuesday, January 14, 1986

'Owner's Trust' Technique May Open Door to Flood Of New CMO Offerings

By David Zigas

WASHINGTON, Jan. 13 — A new wrinkle in the structure of collateralized mortgage obligations, recently devised by investment bankers, may clear the way for billions of dollars of CMO arbitrage offerings.

In a CMO, a borrower pledges mortgages or mortgage-backed securities to secure bonds that are sold in three or more classes of maturities. The issuer shifts the monthly payments from the pledged mortgages or mortgage securities to accommodate the holders of the CMO issue's short-, medium-, and long-term securities.

The new wrinkle, called an "owner's trust," is designed to allow CMOs to be sold without piling up debt on the issuer's books. Even though mortgage assets are pledged to secure the borrowing in a CMO, accountants have insisted that the bonds be consolidated on a firm's books as debt. This has kept the volume of CMO arbitrage offerings down because too much borrowing, especially in the large amounts of most CMOs, reflects unfavorably on financial statements.

Since the CMO was invented three years ago, bankers have been looking for a way to arbitrage mortgages and mortgage securities, by reselling them as CMO-structured debt, without adding debt to their books. Bankers make arbitrage profits when they obtain the mortgage securities cheaply enough to wring out a profit from reselling the securities in a CMO.

Only one CMO issue using the owner's trust structure has been sold so far, a $200 million offering by Morgan Stanley & Co. last November. But recent filings with the Securities and Exchange Commission indicate plans for large amounts of CMO borrowing using the new technique.

Shelf registrations have been filed by Morgan Stanley for $1 billion of CMOs, Salomon Brothers Inc. for $2 billion, Drexel Burnham Lambert Inc. for $500 million, and Weyerhauser Inc., the lumber company, for $500 million. To investors, the CMO offerings that would come to market under these prospectuses will look much the same as the billions already sold.

Shelf registration statements are prospectuses that allow an issuer to come to market periodically for up to 18 months without re-registering each offering with the SEC. The procedure saves time and money and allows quick access to the market. The full amount "put on the shelf" does not have to be sold, but 2 basis points, or $200,000 per $1 billion, are paid for the initial filing.

In the owner's trust approach, the traditional finance subsidiary of the investment banker sells the mortgage securities to a newly-created trust, which then borrows cash by selling CMOs and paying them off with income from the mortgage securities.

The trick to getting the CMOs off the books, according to accountants familiar with these deals, is the subsequent sale of the "residuals" that flow from a CMO. Residuals are the gains from reinvesting the cash flows and from the interest rate spread between the payments the issuer makes on the CMOs and the payments he gets from the mortgage securities.

The owner's trust structure allows the issuer to resell the residuals. Accountants have ruled that if at least half of the residuals are sold, the issuer can take the debt off its books.

Thus far, Morgan has not sold residuals from its $200 million issue, but the firm has the flexibility to do so if it needs to limit the borrowing on its books.

The trusts also provide ready-made vehicles for Wall Street firms to peddle to savings and loan institutions and others seeking mortgage arbitrage. Thrifts and banks can buy into existing trusts and issue CMOs, saving the time and expense of registering the deals separately with the SEC.

The interesting time for users of owner's trusts will be when the residuals are actually sold through sales of the trusts. Sears, Roebuck and Co. and its investment banking subsidiary, Dean Witter Reynolds Inc., were bruised by the Internal Revenue Service two years ago when they offered a deal similar to the CMO that used a multiple class grantor trust. In that instance, Sears and Dean Witter were also seeking a structure that allowed the mortgages to be taken off their books. The IRS shut the deal down through a negative tax ruling.

Designers of the owner's trust believe they have improved on the Sears/Dean Witter approach. But whether they are right or not will not be determined until and unless CMO residuals are sold.

At the same time, Salomon and other investment banking firms in the mortgage area are pressing for a proposed law that would permit deals such as the Sears/Dean Witter offering to work without tax problems. Sen. John H. Chafee, R-R.I., chairman of the Senate Finance Committee's subcommittee on taxation and debt management, has planned hearings for Jan. 31 on the bill, known as the Secondary Market Tax Amendment.

EXHIBIT C

EXORCISING PHANTOM INCOME

Phantom income on CMOs may arise when discount mortgages collateralize discount CMOs. If the discounts on the mortgages do not exactly match the discounts on the individual CMO tranches, the CMO issuer may appear to earn income as the mortgages prepay.

The following example illustrates that gains from prepayments accrue in an economic sense to each discount CMO tranche because, as the maturity of a discount instrument shortens, its price rises. But not all classes of CMO investors actually receive cash flow from a given prepayment; instead, the gain is often allocated between investors in the currently payable tranche and the issuer. This causes the issuer to over-report income and investors in later tranches to under-report it. The situation reverses when the longer tranches are receiving principal payments. Thus, the phantom income represents a tax timing problem between issuers and longer-tranche investors.

Example:

An issuer purchases two mortgages, each with a face value of 100 and a price of 90. A CMO is issued with two tranches, both bearing the same coupon rate. To increase the yield on the longer tranche, it is issued with a larger discount than the shorter tranche.

Mortgages Purchased			CMO Issued		
Face Value	Market Value	Coupon Rate	Face Value	Market Value	Coupon Rate
$100	$ 90	8%	$100	$ 95	8%
100	90	8%	100	85	8%
$200	$180		$200	$180	

If one of the mortgages prepays immediately, an economic gain of $10 occurs. The question is, to whom does it accrue in an economic sense?

The issuer receives $100 and passes it through to the first tranche investors. The issuer has no economic gain. Investors in the first tranche experience an economic gain of $5 ($100 − $95), which they receive in cash. The second tranche investors also experience a gain of $5 because future cash flows will accelerate. They do not receive cash, but the market value of the second tranche increases from $85 to $90 to reflect the new expected timing of future cash flows.

For tax purposes, however, the $10 economic gain may be recognized differently. The first tranche investors recognize the $5 income for tax purposes, but the issuer recognizes the $5 in taxable income that accrues in an economic sense to the second tranche investors. The $5 income reported by the issuer when the the first mortgage prepays is called phantom income because it represents taxable income, but not economic income.

Not all CMOs have phantom income problems. For example, Freddie Mac's CMOs backed by discount mortgages are, for the most part, issued at par. Thus, any economic gain from prepayment accrues to and is recognized by Freddie Mac. Even if this structure is not used, an issuer can avoid phantom income by allocating taxable income from prepayments according to the way it accrues economically. The Department of the Treasury has not ruled on allocating gains from prepayments on mortgages or CMOs. Because it does not distort income recognition, allocation based on economic gain should be acceptable.

Issuer's Taxable Income

	Cash Received	−	Original Investment	=	Income	−	Deductions for Interest Payments To Investors	=	Taxable Income
First Mortgage Prepays	$100	−	$90	=	$10	−	$5	=	$5
Second Mortgage Prepays	$100	−	$90	=	$10	−	$15	=	−$5

Issuer's Economic Income

	Cash Received	−	Original Investment	=	Income	−	Deductions for Interest Payments to Investors	=	Economic Income
First Mortgage Prepays	$100	−	$90	=	$10	−	$10	=	$0
Second Mortgage Prepays	$100	−	$90	=	$10	−	$10	=	$0

STATEMENT OF ROBERT B. WEBER, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, SAVINGS BANK OF PUGET SOUND, SEATTLE, WA, ON BEHALF OF THE NATIONAL COUNCIL OF SAVINGS INSTITUTIONS

Mr. **Weber**. Mr. Chairman, my name is Robert Weber. I am chairman and chief executive officer of the Savings Bank of Puget Sound in Seattle, WA. As a member of the Board of Directors of the National Council of Savings Institutions, I am pleased to have the opportunity to present a brief summary of the views of the council on these proposed bills.

Senator **Chafee**. Please, sir, what is the difference between your two organizations? Do you have similar members?

Mr. **Weber**. I believe some members are common, sir. The National Council of Thrift Institutions resulted from a merger several years ago of the old National Association of Mutual Savings Banks and the National Savings League, which was a group of savings and loans.

Mr. **Wise**. The U.S. League, Mr. Chairman, if I might interject, is a substantially larger organization representing in excess of 90 percent of the assets of the savings institutions business.

Senator **Chafee**. Would the bigger insitutions tend to belong to your organization or isn't that clear?

Mr. **Wise**. Our organization represents almost all institutions in the business. There are some who have memberships in both organizations.

Senator **Chafee**. All right, fine. Thank you. Won't you proceed, Mr. Weber?

Mr. **Weber**. As outlined in the report of the President's Commission on Housing, mortgage-backed securities are disadvantaged from a legal, regulatory, and tax standpoint in their competition with corporate debt obligations. This proposed legislation would alter the structures through which mortgage-backed securities are issued to allow active management of the cash flows generated by, pools of mortgages, resulting in the creation of multiple term mortgage-backed securities. This is significant because the current treatment of mortgage-backed securities under the grantor trust provision of the Internal Revenue Code requires that pools be passively managed and therefore restrict the mortgage-backed securities to the terms and cash flows of the underlying mortgages. Passive management requirements restrict the market for mortgage-backed securities to certain institutional investors by keeping mortgage-backed securities essentially long-term assets.

The usefulness of mortgage-backed securities as an asset will increase for the largest class of investors, mainly savings institutions, with this proposed legislation in that it provides a wider diversity of maturities of assets to match term liabilities. The National Council supports the elements of both bills and urges the subcommittee to act favorably on legislation to unfetter mortgage-backed securities from restrictive tax regulations.

We believe it would be possible to do so in a revenue neutral manner that will benefit all participants in the mortgage market, including home buyers, builders and lenders. The legislation would facilitate the creation of shorter term securities that would ideal investments for thrifts who are trying to match their assets and liabilities.

The need for more matchable assets has been brought about by a combination of monetary policy, market conditions, and statutory changes that have made the flow of funds to thrifts more volatile and a more expensive source of money. Passage of this legislation will also increase the opportunities for savings institutions to increase fee income to the origination of sale and servicing of mortgages.

It is critical that thrifts insulate themselves from the interest rate risk associated with portfolio lending. Finally, we state our support for the inclusion of Fannie Mae, Freddie Mac, and Ginnie Mae and any new mortgage-backed security programs. The activity of the agencies in the market bolsters liquidity and, in many cases, is really the only practical whole loan take-out market for smaller institutions and institutions in smaller communities.

Mr. Chairman, thank you for the opportunity to testify, and I will be happy to answer questions if I can.

Senator CHAFEE. Thank you very much, Mr. Weber.

Mr. Harkins?

[The prepared statement of Mr. Weber follows:]

Statement
of the
National Council of Savings Institutions
on S. 1959 and S. 1978
before the
Committee on Finance
Subcommittee on Taxation and Debt Management
United States Senate
January 31, 1986

Mr. Chairman, my name is Robert B. Weber and I am the Chairman and Chief Executive Officer of the Savings Bank of Puget Sound. As a member of the Board of Directors of the National Council of Savings Institutions, I am pleased to have the opportunity to present the views of the Council on S. 1959, the Secondary Market Tax Amendments of 1986 and S. 1978, the Recovery Act for Mortgage and Other Asset-Backed Securities.

The National Council was formed two and a half years ago by the consolidation of the National Association of Mutual Savings Banks and the National Savings and Loan League. We represent almost six hundred savings banks and savings and loans with total assets approaching $450 billion, or approximately 40% of the thrift industry's assets.

Since we represent lenders very active in the residential mortgage market, the Council supports passage of legislation to remove statutory impediments to the development of a broad range of mortgage-backed securities (MBS). We testified before this Committee in November of 1983 in support of the Trusts for Investments in Mortgages (TIMs) proposal and are pleased to have the opportunity to testify this morning. Mr. Chairman, you are to be commended for beginning the work on the major tax issues affecting the secondary market by holding these hearings, and we look forward to working with the Committee in the future on this legislation.

The two bills before the Subcommittee today reflect the creativity that has been occurring in the market for the past three years with the development of collateralized mortgage obligations (CMO's). Each bill takes a somewhat different approach to the problem that must be addressed. The National Council supports elements of both bills and urges the Subcommittee to act favorably on legislation to unfetter MBS from restrictive tax regulations. We believe it will be possible to do so in a revenue neutral manner that will benefit all participants in the mortgage market including homebuyers, builders, and lenders.

Why is it important for savings institutions to be able to have a wider range of options with respect to MBS? The answer is that flexibility, manageability, and liquidity of assets are crucial to the successful functioning of these institutions today. The financial crisis faced by the thrift industry was brought on in large part due to our excessive reliance on long-term, fixed-rate mortgages. These fixed assets continue to stay on our books as the cost of our funds has fluctuated widely. These mortgages simply do not lend themselves to the complexities of today's financial marketplace. Adjustable rate mortgages are part of the answer but they are not the total solution.

Furthermore, passage of legislation would increase the opportunities for savings institutions to increase fee income through the origination, sale, and servicing of mortgages. It is critical that thrifts insulate themselves from the interest rate risk associated with portfolio lending.

Background

When the President's Commission on Housing published its report in the Spring of 1982, it listed several statutory and regulatory problems confronted by MBS. The report noted:

> "mortgage-related securities issued for sale in the secondary market currently are disadvantaged from a legal, regulatory, and tax standpoint in their competition with corporate debt obligations."

The report recommended several specific regulatory and legislative actions, and some of these regulatory changes have been made:

—The SEC has allowed "blind pools" which enable securities to be sold before the actual mortgages are made;

—The SEC has allowed "shelf registration" for multiple issuances of similar MBS; and,

—The Federal Reserve Board has amended Regulation to "T" to allow MBS to be purchased on margin.

While these regulatory changes have improved the climate for the development of MBS, tax law, requiring legislative action, still constrains the process. The bills before you today, Mr. Chairman, follow through on the recommendations of the Commission's report, and I can say that the National Council supports this effort.

Passive Management--The Cause of the Problem

The bills before the Subcommittee would establish the statutory foundation to assure the full development of MBS and assist America's homebuying public in finding adequate supplies of mortgage credit in the years to come. Of equal importance, this legislation would enable the market to supply this capital by enabling MBS to compete in capital markets.

The legislation would alter the structure through which MBS are issued to allow active management of the cash-flow generated by pools of mortgages. This is significant because the current treatment of MBS under the grantor trust provision of the Internal Revenue Code requires that pools be passively managed. Therefore, the issuer of the security must transmit all payments of interest and repayments of principal on a monthly, *pro rata* basis to all holders of securities. The grantor trust also requires that all securities tied to a specific pool of mortgages represent an equal and undivided share of the assets (the pool of mortgages).

This means that all securities backed by the same pool of mortgages must have the same term. In the case of issues backed by new mortgages this means a fairly long term. Furthermore, they can offer almost no call protection to securities holders. That is to say, the investor seeking long term investments has no assurances that his investment will not prepay quicker than expected.

When the requirements of passive management of cash flows are not followed, the flow of interest is taxed as it goes from the mortgagor to the securities issuer and then again when the issuer transmits that interest to the security holder. This double taxation makes the option of active management prohibitively expensive. Passive management requirements restrict the market for MBS to certain institutional investors. The quality of the MBS as an asset is reduced for the largest class of investors, savings institutions.

The Importance of Passage of Multiple Class MBS Legislation

The creation of multiple term MBS would enable the creation of, for example, two, five, eight, and fifteen year securities backed by the same pool of mortgages. The shorter term securities would be ideal investments for thrifts trying to better match assets and liabilities by garnering shorter term assets.

The legislation before the Subcommittee would enable MBS issuers to:

—establish multiple classes of securities with short-term securities' holders receiving principal repayments before holders of interim and long-term securities; and

--provide the long-term investor with increased call protection; and

--create bond-like investments with semi-annual payments of interest and payments of principal at maturity.

These steps are certain to make it possible for new investors to purchase, either directly or indirectly, housing-related securities, thereby expanding the investor pool from the traditional thrift institutions that have historically been the major holder of mortgage paper. Since the new MBS would attract new investors, opportunities for origination and servicing income for thrifts selling loans would also be enhanced. These securities could be tailored to appeal to institutional investors such as pension funds, bank trust departments, insurance funds as well as to mutual funds and retail customers. The net result will be the attraction of new sources of mortgage financing by experienced housing lenders.

Thrifts could also invest in short-term mortgage-backed securities that would be allowed under these bills. This would help match assets and liabilities, and, as the percentage of housing-related assets continued to shift from mortgages to securities, would lend itself to increasingly sophisticated portfolio management.

As thrifts have found in swapping old mortgages for securities, securities are more liquid and manageable than the mortgages themselves. Since a critical feature of the bill from the thrift viewpoint is the creation of good, manageable assets, it is important to assure that any new securities qualify under the tax code for qualified mortgage investments for thrifts (Section 593 of the Internal Revenue Code).

Thrifts and MBS

Thrift institutions have been the largest single class of investors in mortgage-backed securities. At the end of 1985, thrifts held approximately $108 billion of the total $450 billion MBS issued. As I mentioned earlier, MBS are more flexible assets than whole loans. They provide the thrift with numerable options such as collateralized borrowings or other financing techniques not readily done with mortgages themselves.

However, due to the tax code's requirement of passive management of cash flows, the mortgage-backed securities have many of the characteristics of the mortgages themselves, the most important one being the term of the asset. Since mortgage-backed securities must be paid off as the mortgages are retired, they are essentially long-term assets. If the expected life of mortgages in a pool securing securities is, for example, twelve years, then the mortgage-backed securities are twelve year investments.

In spite of the existing limitations on mortgage-backed securities, thrifts have been moving to alter the form of their mortgage investments in increasing amounts. In 1985, FNMA and FHLMC issued over $60 billion of MBS, much of which was devoted to the exchanging of old, seasoned loans for securities by thrift institutions.

Why do institutions convert (or securitize) their mortgages, a transaction which does cost money? The answers are that securities can be sold more quickly and with shallower discounts than mortgages; they can be used as collateral for certain loans; and they offer asset managers other options. For a description of several asset based financing options for thrifts presented by MBS, please refer to attachment #1.

The need for more manageable assets has been brought about by technological, market, and statutory changes that have made the flow of funds to thrifts a shorter-term, less predictable and more expensive phenomenon. The volatility of interest rates experienced between late '79 and early '82 has thankfully abated, but we see no one guaranteeing that we will not experience similar scenarios in the future.

CMO's--Multiple Class Mortgage Related Securities

FHLMC's issuance of the first CMO two years ago was the initial development in a series of events in which investors have acquired the rights to the cash flows generated by various forms of installment debt. Car loans, commercial real estate loans, and even credit card debt are some of the loans that have been securitized. Fundamentally, all these transactions are the same: Loans are pooled in numbers sufficient to minimize risk to the investor; warranties are made as to the quality and characteristics of the collateral, with some sort of pool insurance to back it up; and cash flows from the collateral are altered to suite the needs of the investor. The changes in cash flow could be the creation of quarterly or semi-annual payments from loans that are paid monthly, for example.

The benefits of active management have been demonstrated by the development of CMO's. CMO's offer investors a variety of maturities in a single issue so that the life of their investment is not totally dependent on the prepayment characteristics of the pool of mortgages. They have the major advantage of appealing to investors that might not be interested in the usual mortgage security, which is limited to one fairly long-term maturity. In addition, it is possible to offer investors quarterly or semi-annual payments, zero coupon bonds, and other important features.

CMO From The Thrift Perspective

The CMO is a relatively new instrument that allows savings institutions to liquidate below market rate mortgages without having to record a loss to net worth. The flexibility of the CMO allows the institution to tailor its mortgage related debt to appeal to a wide spectrum of investors. In 1985, thrifts were the largest class of CMO issuers. In the past year and a half, conduits have been established that enable even small institutions to participate in CMO programs. Thrift issuance of CMO's is expected to continue for the reasons I outlined below.

The CMO is a multiple term mortgage-backed bond that enables the issuer to use a positively-sloped yield curve to seek the most cost-effective means of raising funds. Using a pool of mortgages or mortgage-backed securities as the source of a cash flow, the issuer of the CMO can offer investors bond-like instruments with a variety of maturities.

Since a CMO creates a variety of maturities of debt, it can be structured to take advantage of the shape of the yield curve, with more debt being carried in the lower cost maturity ranges. In an environment in which the yield curve is upward sloping, this will reduce the overall cost of financing mortgage product. This is because the value of a mortgage is calculated on the assumption that it is 12 years in maturity, using a fairly new mortgage, for instance. By enabling shorter term (and cheaper) debt to be funded by those long-term mortgages, substantial savings can be realized.

The CMO represents the most efficient use of mortgage collateral in a way that offers maturity flexibility to the thrift. It matches seasoned long-term assets with intermediate term liabilities, thus reducing the maturity gap that plagues most thrifts.

An institution issuing a CMO must meet the guidelines established by the rating agencies in order to acquire a Triple A rating. The Triple A rating not only lowers the borrowing costs, it has become a standard rating for publicly issued CMOs. Any institution, regardless of its health, can get this high rating if it follows the agencies' instructions.

Upon the issuance of the CMOs, the proceeds are remitted to the issuing institution, with the ongoing cash flows generated by the collateral going to the investors.

There are a number of potential uses for a CMO. Among other things, the CMO can offer an institution the opportunity to:

—Liquefy underwater mortgages without having to record the loss that would occur if those loans were sold;

—Lower the cost of funds by borrowing on the basis of mortgage collateral in an efficient way;

—Supplement sources of funds and move away from dependence on retail deposits;

—Arbitrage against a positively sloped yield curve by converting idle mortgages into short term borrowings and investing the proceeds in high-yield marketable assets; and

—Extend the term of its liabilities since the CMO offers long-term borrowing opportunities that otherwise might not be available.

Participation of FNMA, FHLMC, and GNMA in Multiple Term MBS

While both these bills would authorize multiple class mortgage-backed securities in different ways, they are both consistent in allowing the federal secondary market agencies, FNMA, FHLMC, and GNMA, to participate in the programs. The Council supports this approach as consistent with the experience garnered in the marketplace. The vast majority of CMO's issued to date employ the collateral of these agencies' securities. The activity of the agencies in the market would bolster liquidity, innovation, and the rapid development of a broad market, including the ultimate development of private multiple class pass throughs.

Liquidity: Liquidity in the mortgage-backed securities market is predicated on a large volume of similar products, with a continuing production of similar securities. It is a market where the blooming of a thousand flowers may thwart a truly liquid market. Without liquidity for these securities, one of the primary goals of the legislation, tailoring securities to better meet the needs of investors, will not be met.

Innovation: By allowing the three secondary market agencies to participate in these loan programs, the period of innovation and product development will be allowed to occur in the most favorable environment. Since Fannie Mae decided to jump into the MBS business in 1981, market participants have viewed an intense and imaginative competition between Fannie Mae and Freddie Mac. The beneficiaries of this creative struggle have been homebuyers, builders and lenders. By enabling these entities to employ their market experience in this new area will establish an invaluable laboratory environment. As private issuers have benefited from the pioneering of FNMA and FHLMC MBS in the past, we can only assume they would similarly benefit from future involvement.

Rapid Development of a Broad Market: With the market recognition and federal support for the agencies and their securities, broad investor acceptance of these new instruments will be enhanced, and, in fact, may be essential. Once again, we must point out that private issuers of these securities will benefit from having agency securities in the market. They will be able to structure deals in similar formats, and will be priced off of the agency securities.

Another development that would result in the agency participation would be the development of standards to assure that no disasters could occur that have with respect to some privately issued, unrated MBS in the past year and a half.

To provide a framework for considering the involvement of the secondary market agencies, we will propose two opposite hypotheses and see where they lead us. The first is that the market would not accept totally private MBS backed by whole loans. If the agencies are excluded, the danger is that passage of this legislation may be an academic exercise.

On the other hand, where are we if the private multiple class MBS markets thrive and the agencies are excluded. Where does that leave the agencies, and all the rest of the participants in the mortgage markets? First, lets look at FNMA. If Fannie Mae could not compete with private firms with its plain vanilla, passive management MBS it would be severely limited in its ability to be a creative force in the market, and more importantly, to survive. Such a scenario would leave FNMA only in the MBS business for providing collateral for CMO's and financing options discussed in attachment #1. This is a finite market and will restrict FNMA's ability to garner fee income significantly.

In order to compete for new mortgage business, it would have to approach this as a portfolio lender. Since it would be competing with the likes of multiple class securities which would require lower yields, it would be placing less than favorable assets in its portfolio. Regardless of the quality of these assets, putting FNMA back into the mode of a portfolio lender exposes it to interest rate risk, since it will have to fund the purchase of these fixed rate assets with floating rate debt. In fact, the department of HUD which is responsible for some of the government oversight of the agency, has been encouraging FNMA to leave the portfolio business. Of course, this is a message that need not even be delivered, since the current FNMA management has been wisely decreasing emphasis on portfolio lending and attempting to increase fee income. The issuance of multiple class MBS is an ideal source of this fee income. The same arguments about portfolio lending holds for the thrift industry, and we will address that point later in our statement.

By putting FNMA in a risky situation, you not only place the Treasury in risk of tremendous exposure, but you threaten a catastrophe in our financial markets of monumental proportions. All holders of existing FNMA MBS, debentures, notes and stock would be damaged, and the fraternity of these investors now extends around the world.

FHLMC would also be placed in a weakened position should these bills exclude them and spawn an overnight development in an otherwise latent private MBS market. FHLMC would be relegated to simply swapping.

Other Observations on the Legislation

The Council has not developed policy on the ability of non-mortgage assets such as those contemplated in S. 1978 to be included in multiple class securities.

We are somewhat concerned about what appears to be onerous reporting requirements for issuers of CMO's as presented in S. 1959. Such requirements would drive up the overall costs of these borrowings for thrifts issuing CMO's.

The Multiple Class MBS and the Thrift Asset Test

Another critical issue facing the thrift industry is the question of a thrift assets test. While this is an issue that has found its way into deliberations on banking bills, S. 1978 and S. 1959 have a direct bearing on the wisdom of a requirement that a statutorily proscribed class of assets be held.

If thrifts will be required by law to hold a significant portion of their assets in mortgages, then it is probably self-defeating public policy to expand the potential investor universe in mortgage-related products as embodied in these bills. By making mortgage-backed securities more attractive investments for pension funds, commercial banks, insurance companies, and international investors, you will inevitably lower the yields on those assets to be held by thrifts. So, you can have a thrift asset test and make it work only by making the thrifts the only government-sanctioned or supported mortgage investors. Passage of these bills would fly in the face of an assets test.

While the Council supports the bills before the Subcommittee today, we strongly oppose the so-called thrift assets test.

Underwriting of MBS for Depository Institutions

I would now like to focus on another concern of ours with this legislation. Although it is also not within the jurisdiction of this Committee. I am referring to the need for clarification of the authority for depository institutions to underwrite and deal in mortgage-backed securities. The legislation will make it easier for mortgage-backed securities to function in today's capital markets. However, it has a one-sided approach, i.e., making it easier for the investment banking community to operate in the mortgage market without enabling the nation's traditional suppliers of mortgage credit to compete in that market.

Allowing thrifts to underwrite these securities would also open up an important new source of business for the community-based savings institutions. By allowing thrifts to market securities without going through a third party--the investment banker--the flow of funds would be more efficient and less costly. Some of our members have been considering for some time the possibility of packaging mortgage loans that they originate and selling shares in these mortgages to depositors and other local customers. In fact, the Boston Five Cents Savings Bank markets $1,000 participations in FNMA MBS to its depositors with great success.

Savings institutions would be tailoring investments to the needs of our savers while also meeting the needs of our borrowers. If they were allowed to do the issuing and underwriting, major costs could be eliminated and passed on to consumers. Removing an expensive middleman in this operation could in some instances benefit mortgage borrowers and small savers who invest in the mortgage-related securities.

Attachment #1

Several Asset-Based Thrift Financings Employing MBS

The CMO represents one particular device to liquidate existing mortgage produce to acquire funds for alternative investments. There are almost a dozen alternative approaches employing mortgage product to access the wholesale funds market or reduce an institution's asset-liability maturity gap. Three alternative methods, Mortgage-Backed Bonds, Collateralized Commercial Paper and Controlled Preferred Stock, will be analyzed briefly to underscore the fact that a CMO is but one of several possibilities. -

Mortgage-Backed Bonds

Mortgage-backed bonds are debt instruments collateralized by mortgages, Treasury securities, or mortgage-backed securities. They feature semi-annual payments of interest with principal payment at maturity, similar to government or corporate bonds. The amount of the collateral is adjusted periodically to maintain a constant market value. Like CMOs, mortgage-backed bonds are structured to receive the highest rating from the rating agencies which may require the exchange of mortgages for Treasuries or agency securities, or overcollateralization of the mortgages.

Mortgage-backed bonds usually have a maturity of seven to ten years (comparable to the middle trenches of a CMO) and can serve to reduce the maturity gap of the thrift. Mortgage-backed bonds are familiar in foreign markets allowing the thrift to sell abroad when rate differentials offer a cost saving from doing so.

The disadvantage to this alternative is that the bond is priced at a single point of yield curve, not a various points as with the CMO. In addition, investors prefer the greater call protection of a CMO. Finally, since the amount of the collateral must be adjusted to reflect its market value, a sharp upswing in interest rates would force an institution to commit a growing volume of assets to support the bond.

Collateralized Commercial Paper

Collateralized commercial paper is a structured borrowing that allows thrifts to fund mortgage holdings through short-term borrowings. Mortgage collateral is pledged against the issue of commercial paper with maturities of from one day to 270 days, at rates considerably below those available from sources of similar maturity, including the advances of the Federal Home Loan Bank System. For example, the all-in financing cost of a collateralized commercial paper issue in 1984 averaged 10.67 percent, as opposed to the average cost of FHLB advances of 10.88 percent.

There are two drawbacks to collateralized commercial paper issues. The first is degree of overcollateralization. The thrift must pledge up to 200 percent of the face value of the commercial paper in mortgage collateral to secure the rating that will enable it to minimize its costs. As in the case of the mortgage-backed bond, this substantially reduces the attractiveness of the instrument save in those cases where the collateral mortgages cannot be used in other ways. Second, the short term nature of commercial paper means that it does little to improve the maturity gap at most thrifts, and may increase the exposure of the institution to interest rate swings.

Controlled Preferred Stock

Preferred stock issues hold several of the same attractions to savings institutions as do CMOs. They offer an option for the liquidation of low-yielding mortgages without recognizing a loss. As with CMOs, the mortgage collateral is the primary feature in determining the rating for the preferred stock of the subsidiary issuer.

Controlled preferred stock is a financing device that uses the tax system to arbitrage between issuers looking for a low cost source of funds and buyers seeking some degree of income shelter. The stock can be used by either mutual or stock institutions, as the mutual can organize a financing subsidiary whose purpose is to issue the stock against mortgage collateral transferred from the parent.

To issue controlled preferred stock the institution establishes a finance subsidiary either directly or through a service corporation. The institution purchases all the common stock of the newly established corporation with mortgages, mortgage-backed securities, or other assets that would be appropriate collateral for the issuance of the preferred stock. The finance subsidiary then issues preferred stock backed by the mortgages or mortgage-backed securities. The rate of payment of dividends can be fixed or adjustable.

These stock issuances are attractive to thrifts because corporate investors are exempt from taxes on 85% of the dividends of preferred stock. Therefore the nominal rate on such an investment can be much lower than the rate on other comparable investments, and still be competitive on an after-tax basis.

For instance, assume an institution offered a CMO to investors at 14 percent. Even after deducting the interest payments on the CMO from taxable income, the cost of funds is still quite high. The after tax yield to the corporate investor paying the 46 percent corporate tax rate will be 7.56 percent. With the intercorporate dividend exclusion, that same institution can offer preferred stock of comparable duration to the CMO, and the same corporate investor would require a yield of only 8.12 percent to net the same after-tax yield on the investment.

Since the preferred stock is priced near tax-exempt levels, it provides interesting options. However, preferred stock can only work for institutions with unused net operating losses (NOLs). NOLs are necessary because the dividend payments to holders of preferred stock are not deductible, as would be the interest payments on mortgage-backed debt.

STATEMENT OF PETER B. HARKINS, SENIOR VICE PRESIDENT, REAL ESTATE FINANCE DIVISION, NATIONAL ASSOCIATION OF REALTORS, WASHINGTON, DC

Mr. HARKINS. Thank you, Mr. Chairman. My name is Peter B. Harkins, and I am senior vice president of the Real Estate Finance Division for the National Association of Realtors. And on behalf of the more than 700,000 members of the association, I want to thank you for the opportunity to appear here today in support of legislation to clarify the tax treatment of multiple class mortgage-backed securities. I also would like to digress just for a moment to tell you that, a little more than 2 years ago, I was the staff director of the Senate Housing Subcommittee, and I make that point only by way of drawing the analogy between what you are doing here today to clarify and update the tax laws and the attempt by the Senate and of course the Congress to update the securities and financial institution investment laws under the Secondary Mortgage Market Enhancement Act. There is an important direct correlation in trying to bring these bodies of statute into line to make the issuance of multiple class securities and mortgage-backed securities generally more efficient in the marketplace.

The National Association of Realtors has consistently supported the development of mortgage-related securities designed to attract investment in real estate. In addition, the association supports the clarification of current tax laws and particularly the grantor trust rules which would permit the development and issuance of multiple class securities without incurring tax treatment as an actively managed trust. Last October the national association joined in a letter, along with several other housing and finance trade groups, encouraging the introduction of this legislation that you are considering today. We applaud the need of the focus of this hearing and, of course, believe that the two bills give a range of approaches toward solving problems that have been identified.

As you know, the secondary mortgage market has become increasingly important for the development of mortgage capital in the marketplace. BV purchasing mortgages from loan originators, pooling them in securities, backed by these mortgages, and selling the securities to investors, the secondary mortgage market provides a continual source of housing credit—and an ever-expanding one, I might note—which has provided home ownership opportunity for literally thousands of Americans. Not only does the secondary market provide a liquidity tool for mortgage originators, but can be used by lenders to restructure their portfolios and contributes to reduced interest rates, thus benefiting—and, of course, this is the ultimate purpose—the home buying public. The secondary market has grown at an outstanding rate. The total amount of outstanding publicly issued mortgage-backed securities has grown from $110 billion in 1980 to over $375 billion as of the end of 1985, a truly astounding figure.

Clearly, the secondary market has become a significant player in the financial credit markets. Unfortunately, the tax laws which govern the operation of this market have not been updated to reflect its phenomenal growth. It seems ironic that a major segment of this huge market attempts to operate largely on trust laws written to govern family trusts.

A great deal has been done, however, to remove legal and regulatory barriers, and I have mentioned that through the passage of the Secondary Mortgage Market Enhancement Act. Giant strides therefore have been taken toward improving investor acceptance of mortgages as competitive investments and also fostered the entrance of the private sector into the secondary marketplace. Notwithstanding the importance of legislative improvements, the marketplace has itself been creative in nurturing the growth and attractiveness of the market. For example, Freddie Mac's innovative invention of the CMO is a prime new contributor to bringing more capital because the traditional mortgage-backed pass through security provides investors with little or no call protection, that is protection against prepayment of principal. The CMO provides investors with different maturity classes to select from and a more guaranteed—not entirely—but certainly a more guaranteed flow of income responsive to their investment needs. The CMO has been especially instrumental in helping to attract pension fund investors to this marketplace.

To be sure, these improvements have made a significant positive mark on housing. However, there are still the impediments which you are addressing today, which remain to be eliminated. The tax law governing the secondary mortgage market are not flexible enough to fit the unique character of all mortgage-related securities. As a matter of policy—and this is something, as a matter of fact, Mr. Chairman, my committee of the association has been considering—we prefer S. 1959 for all the reasons that have been stated here by previous witnesses.

I want to close with one final thought, that we are particularly concerned that the bill not be prohibited—or that the benefits of the bill—not be prohibited to the federally chartered mortgage agencies. We believe they play a uniquely important role in the marketplace and should enjoy the same benefits that all other issuers enjoy as well. Thank you very much.

Senator CHAFEE. Thank you, Mr. Harkins.

Ms. Peters.

[The prepared statement of Mr. Harkins follows:]

STATEMENT OF
PETER B. HARKINS
ON BEHALF OF THE
NATIONAL ASSOCIATION OF REALTORS®
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE
JANUARY 31, 1986

Mr. Chairman, my name is Peter B. Harkins, and I am Senior Vice President of Real Estate Finance for the NATIONAL ASSOCIATION OF REALTORS®. On behalf of the more than 700,000 members of the ASSOCIATION, I want to thank you for the opportunity to express our views on pending legislation which would clarify the tax treatment of multiple-classed mortgage-backed securities.

The NATIONAL ASSOCIATION OF REALTORS® has consistently supported the development of mortgage-related securities designed to attract investment in housing. In addition, the ASSOCIATION supports the clarification of current tax laws, in particular, the grantor trust rules, which would permit the development and issuance of multiple-classed mortgage-backed securities without incurring tax treatment as an actively managed trust.

Last October the NATIONAL ASSOCIATION OF REALTORS® signed a letter, along with several other housing and finance trade groups, encouraging the introduction of legislation designed to make these tax law clarifications. We are especially pleased that you and Senator Cranston have introduced such legislation, and Mr. Chairman I applaud you and members of your subcommittee for considering this issue early in this session of Congress. This hearing provides a sorely-needed focus on a subject which is a crucial part of the future housing finance system.

As you know, the secondary mortgage market has become increasingly important to the development of mortgage capital in the marketplace. By purchasing mortgages from loan originators, pooling them into securities backed by those mortgages, and selling the securities to investors, the secondary mortgage market provides a continual source of housing finance which has provided homeownership opportunities for thousands of Americans.

Not only does the secondary market provide a liquidity tool for mortgage originators, but it can also be used by lenders seeking to restructure their portfolios. And, of significant value, the secondary mortgage market contributes to reduced interest rates, thus benefiting the homebuying public.

Because of the success in attracting investors to mortgage-related securities, the secondary mortgage market has grown at an outstanding rate. Over the past five years, for example, the total amount of outstanding publicly-issued mortgage-backed securities has grown from $110 billion in 1980 to over $375 billion as of the end of 1985.

As you pointed out in your introductory statement, Mr. Chairman, this amount approaches the total outstanding publicly-issued corporate securities, which, in 1984, was a little over $400 billion. Clearly, the secondary market has become a significant player in the financial and credit markets. Unfortunately, the tax laws which govern the operation of this market have not been updated to reflect its phenomenal growth.

A great deal has been done, however, to remove legal and regulatory3barriers which have previously stifled the growth and development of the secondary mortgage market, as well as its ability to compete with other investment instruments in the marketplace. The Secondary Mortgage Market Enhancement Act, adopted by Congress in 1984, for example, made giant strides toward improving investor acceptance of mortgages as competitive investments and also fostered the entrance of the private sector into the secondary mortgage marketplace. The NATIONAL ASSOCIATION OF REALTORS® strongly supported this legislation, and we are pleased to see its provisions operating positively in the marketplace today.

Notwithstanding the importance of legislative improvements, the marketplace has also taken creative steps to nurture the growth and attractiveness of the secondary market. For example, Freddie Mac's innovative invention of the CMO, collateralized mortgage obligation, made a valuable contribution to the marketplace. Whereas the traditional mortgage-backed passthrough security provides investors with little or no "call protection", the CMO provides investors with different maturity classes to select from, depending on their investment needs. Therefore, short-term investors can select a class which will provide a certainty of short-term maturity, and those seeking a medium-term investment can also be served.

To be sure these improvements have made a significant positive mark on housing. However, there are some impediments, principally in the tax area, which still remain to be eliminated. The tax laws governing the secondary mortgage market are vague and do not fit the unique character of mortgage-related securities. As you know, the grantor trust rules were written with family trusts in mind, not mortgage-related securities.

Although existing tax law permits the issuance of the CMO, the Treasury Department has ruled that a multiple-classed mortgage-backed security violates the passive requirement under the grantor trust rules. Under this ruling, both the issuer and the investor would be taxed. Despite the excellent performance of mortgage-related securities, this "double taxation" would certainly reduce the financial benefits, and thus, investor interest in these instruments.

The collateralized mortgage obligation continues to be an outstanding instrument which has attracted many new sources of investors in housing. However, clarification of the tax laws to permit a multiple-classed mortgage-backed security issuance under the grantor trust rules would be the next logical step toward promoting efficiency in the secondary market, and there are distinct advantages to utilizing the grantor trust scheme:

- For example, in a trust arrangement, the issuer does not need to retain an equity interest in the mortgages, and thus the issuer avoids a myriad of legal burdens because, once again, the law is ambiguous as to whether the issuer is required to retain this equity interest;
- The financial transaction can be classified as a sale of assets, rather than a sale of debt, which means that the transaction doesn't need to be listed as a liability on a financial entity's balance sheet; and
- Although CMOs are certainly mortgage-related, since they are backed by pools of mortgages, they are not classified as such under current IRS rules which require a thrift institution to invest at least 60 percent of its assets in mortgages and mortgage-related investments. Under a grantor trust format, multiple-classed mortgage-backed securities would qualify as a mortgage investment. Removing this obstacle would provide the opportunity for more thrift institutions to invest in these instruments.

Another tax issue which needs to be addressed involves the calculation of original issue discount (OID) on multiple-classed mortgage-backed securities, which would be permitted if the grantor trust rules were clarified. Because of the prepayment character of mortgages, the normal method of calculating OID, the constant yield method, simply is not an accurate mechanism for these mortgage securities. If the constant yield method is used, there is a strong likelihood that both investors and issuers will be either over- or undertaxed, and we believe that everyone's interests will be better served when this specific problem is resolved.

Mr. Chairman, we are convinced that the enactment of legislation which would clarify these inappropriate and anachronistic tax rules would be of significant benefit to the housing and finance industries. And, because healthy housing and finance industries also promote the health of other related industries, we believe that a broader spectrum of interests will also benefit from these changes.

By eliminating the ambiguity and confusion which act as inefficiencies in the marketplace, more investors will be attracted to these investments, thus broadening the pool of available mortgage finance. This additional investment will also reduce the cost of mortgage credit. Although we do not yet have any data to indicate what the actual reduction in interest rates would be if clarifying legislation was adopted, we do know that our analysis has demonstrated the positive effect of the CMOs on the mortgage market. Some estimates of the benefits of CMOs have ranged anywhere from 25 to 89 basis points. Our studies indicate that CMOs have narrowed the spread between the monthly yield on conventional mortgages and the monthly yield on 10-year treasury securities by more than 30 basis points.

We think that the development of a marketable multiple-classed mortgage-backed security will have a similar positive effect on the mortgage market, and we are in the process of analyzing what these benefits would mean in terms of the mortgage interest rate. As soon as these economic analyses are completed, Mr. Chairman, we will be happy to share them with you and the members of your Subcommittee.

Because of the significant impact that the secondary mortgage market has on the housing, finance, and credit markets, in general, Mr. Chairman, we strongly believe that now is the time to "clean-up" these tax provisions which so greatly affect its efficient operation, and thus, its attractiveness to investors. We are concerned about keeping the investment community in "limbo" any longer with regard to the tax liability nature of mortgage-backed securities. Such clarifying legislation will benefit all interested parties--mortgage originators, portfolio lenders, homebuilders, REALTORS®, potential homebuyers, and investors.

It is also our opinion that both the private sector secondary mortgage market entities, as well as the quasi-governmental entities like Fannie Mae and Freddie Mac, should be active participants in any improved market as a result of adoption of clarifying tax legislation. We do not believe that any rationalizing tax legislation that is adopted should benefit only a certain class of mortgage-backed securities issuers.

Mr. Chairman, we recommend and hope that this subcommittee will adopt legislation to rationalize the existing tax laws which affect the secondary mortgage market.

I appreciate the opportunity to express our views, and will be happy to answer your questions.

Thank you.

STATEMENT OF HELEN PETERS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, FINANCIAL STRATEGIES, SECURITY PACIFIC NATIONAL BANK, NEW YORK, NY

Ms. Peters. Thank you, Mr. Chairman. My name is Helen F. Peters. I am president of Security Pacific Financial Strategies, Inc., a subsidiary of Security, Pacific National Bank. I am testifying today on behalf of Security Pacific Corp. and its subsidiaries. These include Security Pacific Financial Strategies as well as the mortgage banking subsidiary, capital markets group, and the bank itself.

My distinguished colleagues on this and previous panels have made several points which highlight the many advantages to the financial services industry and to the consumer that would ensue from the development of multiclass passthrough securities. I support these conclusions and including those that relate to Fannie Mae and Freddie Mac and other entities involved in these securities; but I would also like to add two additional points that have not been covered by the speakers today. These come from two perspectives. The first is taken from the perspective of Security Pacific Bank, the seventh largest bank holding company and a holder of many of the assets that are discussed in the bills today.

And the second perspective from one who has been trained as an academic, has worked on Wall Street, and as a regulator, and it buys its pension funds. U.S. and domestic corporations, thrifts included, on risk reduction and perhaps looks at some of these points from a different angle.

Security Pacific Corp. is an originator of commercial loans, real estate loans, farm and agricultural loans, consumer loans, and student loans. Seventy percent of Security Pacific's assets are interest sensitive. One of the greatest risks that Security Pacific and other banks face is interest rate risk, which is created by funding long-term assets for short-term borrowings. One of the ways the bank mitigates this risk is through loan sales. Security Pacific aggressively used loan sales, particulary about $1 billion in the last 3 years—each year for the last 3 years—and strongly believes that a broader variety of mechanisms to tap the needs of a more diverse group of investors will enable the bank to better manage its portfolio, sell off assets where appropriate, without the concern of not capturing true value in the sales price due to illiquidity in the market at a point in time or with a certain group of investors.

The second point I would like to make—and this one does come from the perspective of someone who works in risk reduction and has advised clients both on purchasing mortgages or mortgage-backed assets, as well as when mortgage assets do not meet their asset and liability needs—I contend there is also a hidden benefit to this bill—that if it is passed, or these bills are passed, they would help develop a better understanding of the mortgage market and the underlying assets. The mortgage market is the fastest growing market, as distinguished by the presence of so many Wall Street people here, but unfortunately, it is the least understood in the capital markets. It has come a long way from mispricing assets with 12-year life and FHA experience, but there is more to learn.

The reason that I would contend that these markets, both the mortgage market and the consumer receivable market, are not well understood is that institutions, the holders and originators, do not track the characteristics of their portfolio and review the history of prepayments and defaults, and how they have operated over different environments. This is due to antiquated computer systems that were better made for tracking principal and interest than tracking value, and due to lack of incentives to review a portfolio and a buy-in hold in an environment where one does not market assets, but for gap and regulatory accounting, uses book value. The growth of asset sales in general has encouraged institutions to take a better look at their portfolio, but multiclass pass through securities goes further and puts a premium on analyzing true worth of expected cash flows and structure them into appropriate asset classes. Of course, those who are most diligent will reap the most rewards, but the industry as a whole will benefit from examples learned from its more prudent brethren. In the final analysis, whether an institution actively uses these instruments or uses them as benchmarks to effectively monitor their current or future asset holdings, we all benefit from safer, sounder, and more astute decisions in our financial institutions.

Mr. Chairman, thank you.

Senator **Chafee**. Thank you, Ms. Peters.

[The prepared statement of Ms. Peters follows:]

Statement of

Helen F. Peters

President

Security Pacific Financial Strategies, Inc.

Before The

Senate Subcommittee on

Taxation and Debt Management

Committee on Finance

January 31, 1986

Tax treatment of Mortgage and

Receivable-Backed Securities

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Introduction

My name is Helen F. Peters. I am President of Security Pacific Financial Strategies, Inc.

I am testifying today on behalf of Security Pacific Corporation and its subsidiaries. These include its Mortgage Banking subsidiary, its Capital Markets Group, and the Bank itself.

Security Pacific Financial Strategies, Inc. (SPFSI) advises domestic and international corporations, institutional investors, pension funds, and asset originators in the optimal management of broad-based asset portfolios. This advice utilizes applied mathematics and high-speed computer analytics in a variety of areas, including portfolio evaluation, securitization, hedging, and arbitrage. Security Pacific's numerous trading units rely on the expertise and various proprietary products developed by SPFSI.

Dr. Peters holds an A.B. Degree in Economics from the University of Pennsylvania, an M.A. in Statistics and a Ph.D. from the Wharton School of the University of Pennsylvania. Prior to joining Security Pacific, Dr. Peters was Vice President and Group Manager of the Debt Strategy Group at Merrill Lynch, an economist and manager of the Research Department of the Federal Reserve Bank of Philadelphia, and Assistant Vice President for the Investment Department of the Philadelphia Savings Fund Society. Dr. Peters serves on the boards of many professional and public interest groups, including the Federal Savings and Loan Advisory Council and the Center for Real Estate and Urban Economics at the University of California at Berkeley.

SPFSI has expertise in mortgage and other asset analytics, and it advises its clients in the optimal use of mortgages. SPFSI has developed programs for portfolio dedication and bond immunization strategies, and products that facilitate thrift-to-thrift, thrift-to-agency, and thrift-to-Wall Street transactions. SPFSI advises municipalities, pension funds, and other institutional investors in the efficient use of mortgages when appropriate. However, SPFSI recognizes that many investment goals may not be met by mortgage assets.

Our Denver, Colorado based mortgage banking subsidiary, Security Pacific Mortgage Corporation, annually originates more than $1 billion of mortgage loans and was the largest issuer of GNMA Securities in 1984.

Our Capital Markets Group, which includes Security Pacific Financial Strategies, Inc. has become a significant factor in international investment banking, stockbroking, and market-making. Our London presence includes partial ownership in John Govett & Co. Ltd. - an investment management firm, as well as a minority interest in Hoare Govett, Ltd. a brokerage house. This will increase to a majority interest as London's financial deregulation continues.

Over the last decade, I have conducted extensive research in the area of Mortgage-Backed Securities. Six years ago, my paper entitled the "Misuse of FHA Experience" pioneered the application of the now widely-used CPR prepayment statistic to mortgage portfolio research and pricing. A study completed for the Federal Home Loan Mortgage Corporation, Freddie Mac, is the only comprehensive treatment of the prepayment and default experience of conventional mortgage loans. This study has been used by Freddie Mac to determine the risk/profitability trade-offs of its CMO issues. The Federal Reserve Bank of Philadelphia and Freddie Mac have published my research.

I am here today to voice my support for 2 pieces of legislation. The first, S. 1978, is entitled the "Recovery Act for Mortgage and Other Asset-Backed Securities," and was introduced by Senators Cranston (D-CA) and D'Amato (R-NY). The second, S. 1959, was introduced by Senator Chafee (R-RI), and is called the "Secondary Market Tax Amendments of 1986."

These two acts would simplify and clarify several long standing taxation questions which presently plague the Mortgage-Backed Securities Market. The resolution of these questions will permit the issuance of multiple class mortgage pass-throughs in a way that will offer investors a choice of maturities with less uncertainty about the prepayment characteristics of the underlying mortgages.

This, in turn, will enable issuers to sell mortgage assets at higher prices, or lower yields, than currently available. Homebuyers will benefit as they receive lower home mortgage rates as a direct result of the more favorable secondary market pricing.

I would like to devote my remaining testimony to explain how the enactment of S. 1978 and S. 1959 will benefit issuers of mortgages and other assets, as well as homebuyers and consumers.

Benefits to Banks: Asset Sales and Net Interest Margin Management

The Security Pacific Corporation is quite proud of its record in domestic net interest margin management. While rates have plummeted over the past 5 years, our own margin, or profit, has been quite stable at about 4%. The Corporation achieved this stability through the careful and prudent management of the risks inherent in its loan portfolio. This portfolio includes:

- Commercial Loans
- Real Estate Loans
- Farm & Agricultural Loans
- Consumer Loans
- Student Loans
- Auto Loans

One of the greatest risks that Security Pacific faces is interest rate risk. This is created by the funding of relatively long-term fixed rate assets by shorter-term deposits and borrowings. Approximately 70% of our rate insensitive assets are held in the form of real estate, consumer, and auto loans. Security Pacific manages the risk of these holdings partly by relying upon asset sales. In each of the last 3 years, Security Pacific has sold roughly $1 billion of real estate loans. These loans sales, to investors, improve our profitability 4 different ways.

First, loan sales reduce the bank's portfolio risk to interest rate swings, by improving the maturity match of its assets and liabilities. Second, loan sales increase the bank's liquidity by quickly converting loans into cash. Third, loan sales permit the bank to raise and improve its capital asset ratio. By the end of 1984, our primary capital ratio stood at 6.24 percent, well above the regulator's minimum capital adequacy targets. Finally, loan sales boost our income by increasing our fees from the origination, securitization, and servicing of loans. For example, between 1980 and 1984, real estate, consumer loan and mortgage servicing fees rose approximately 29%. Clearly the legislation before the committee, which would facilitate loan sales, benefits Security Pacific as well as other banks.

Security Pacific strongly believes that S. 1959 and S. 1978 will benefit the corporation's efforts to maximize the return on its assets and serve our customers. In particular, if S. 1978 were enacted we would be more able to securitize and sell _any_ of the loans in our portfolio. If S. 1959 were enacted we would be encouraged to securitize and sell the _real estate_ assets in our portfolio. In either case, the multi-class structure would facilitate the issuance of such securities.

The reason for this is simple. Multi-class structures remove much of the investor uncertainty with expected future prepayment patterns, and therefore the return, from securitized assets. If both S. 1978 and S. 1959 were enacted, SPFSI will apply our expertise in real estate assets to auto loan and credit card receivables to better structure these various types of assets for both Security Pacific and our other clients.

Benefits to Banks: Consistent with Call Report Revisions

Let me explain how this both benefits the bank and our other SPFSI clients and is consistent with recent regulatory changes in bank reporting requirements.

On October 28, 1985, the Federal Financial Institution Examination Council gave insured banks new incentives to issue pass-through securities. The council did this by revising the way in which asset sales are reported in banks' periodic Call Reports. These revisions greatly facilitate asset sales.

The Call Reports previously instructed banks to apply two different criteria to distinguish between sales and borrowings. There was a risk criterion and a term criterion.

The risk criterion asked whether or not the owner retained any risk in connection with the asset transaction. The term criterion asked whether or not the terms of the sale instrument were identical to those of the underlying asset.

Previously, if any risk was retained or if the terms were not identical, the transactions were reported as borrowings in the Call Report. The revised Call Report instructions basically retain the first, risk, criterion but shed the second, term, criterion. This facilitates the issuance of multi-class pass throughs where the terms of the various classes of securities differ from those of the underlying assets.

Benefits to Homeowners and Builders: Lower Mortgage Rates

The encouragement of multiple class pass through issues by banks and thrifts will benefit the homeowner as well as the lender.

Earlier issues of multiple-class pass throughs reduced the funding costs on various issues. The National Association of Realtors reported that CMOs have produced a quarter point general reduction in fixed rate mortgage yields. This seemingly small change in mortgage interest rates can have a significant impact upon housing starts and home affordability.

The quarter point reduction would make a median-priced new home affordable for an additional 300,000 American families and could result in as many as 30,000 new housing starts per year. According to the

Economics Division of the National Association of Home Builders, the construction of 30,000 single family home generates 52,000 man years of employment and $975 million in wages. The Economics Division estimates that the increased construction, lending, underwriting, and closing activity would produce about $675 million per year in increased tax revenues.

Clearly, lenders, borrowers, builders, as well as the Treasury, will benefit from the passage of S. 1959 and S. 1978.

Benefits to the Financial Industry: Risk Reduction

The proposed legislation would encourage the issuance of multi-class pass-throughs on a host of assets, from mortgage loans to credit card receivables. It should also be viewed as the next step in the evolution of safe and sound financial policy.

Until recently, financial institutions were sheltered by regulatory agencies. This sheltering took two forms. First, both the type and cost of products were closely regulated. For example, passbook accounts possessed fixed interest rate ceilings. Second, regulatory accounting practices discouraged mark-to-market accounting and did not force thrifts and banks to examine the true net worth of their balance sheets.

The refreshing deregulatory trend in the financial services area places a premium upon rigorous analytical inspection of thrift and bank balance sheets. I recently chaired the "Task Force on Current Value Accounting". This Task Force spurred the Federal Home Loan Bank to adopt procedures compelling thrifts to examine their balance sheets' real value. This effort led to the adoption, by the FHLB, of the "Section H" Report which examines the repricing maturities of thrift assets and liabilities. The "Section H" Report is a necessary prerequisite for thrifts to examine and unlock the value of their balance sheet. Multi-class pass throughs, encouraged by S. 1959 and S. 1978, will fairly compensate prudent managers of financial institutions for this value. Specifically, asset originators will originate assets which have value in the secondary market and which can bear up to the scrutiny of mark-to-market accounting and perceptions of value.

The multiple-class pass through is the perfect vehicle to reward profitable, market-oriented asset originators. Using sophisticated analytical techniques, the asset can be restructured to suit the tastes of various classes of investors in ways which will also reduce the funding cost to the asset originator.

Benefits to Be Gained By Inclusion of the Agencies

Security Pacific Corporation for over a decade has been a seller of loans to the Federal National Mortgage Association ("FNMA") and FHLMC. In addition, we have worked with these agencies to develop new programs to facilitate our origination of second mortgages, adjustable rate mortgages and multifamily project loans. It is inconceivable to us that these agencies might be prevented from benefiting from the passage of S. 1959, S. 1978 or a suitable substitute for three reasons.

First, the agencies are the major players in the secondary mortgage markets. Their issues provide stability and liquidity to the still growing and evolving secondary mortgage market. Second, their issues provide pricing benchmarks for all other similar asset issues. Third, the agencies have historically been the primary innovators in the development of new mortgage-based issues. All participants in the secondary mortgage markets, as well as home builders and buyers, will benefit from the agencies' continued and active presence.

We believe that these agencies should be able to issue multi-class and pass-through type securities as well as having their agency collateral used in privately-issued pass-through securities.

CONCLUSION

In reviewing the legislation before the Subcommittee today, I am personally convinced that it would benefit the financial industry, homeowners, builders, the Treasury, the agencies, and Security Pacific.

Financial institutions would benefit from the use of broad-based multi-class structures to maximize its return on assets and manage its net interest margin. Multi-class structures will provide profitable asset originators with market-driven rewards and lower funding costs.

Homeowners, builders, and the Treasury would benefit as the wider use of multi-class pass throughs produces reductions in mortgage interest rates and also encourage additional American home construction and ownership.

The financial industry as a whole will benefit from the inclusion of the agencies - FNMA, Freddie Mac, and the Ex-Im Bank - which provide the necessary critical mass and spur innovation while maintaining stability in the secondary mortgage market.

This concludes my remarks. I would be happy to answer any questions you may have.

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Pricing a Mortgage-Backed Security — The Misuse of FHA Experience

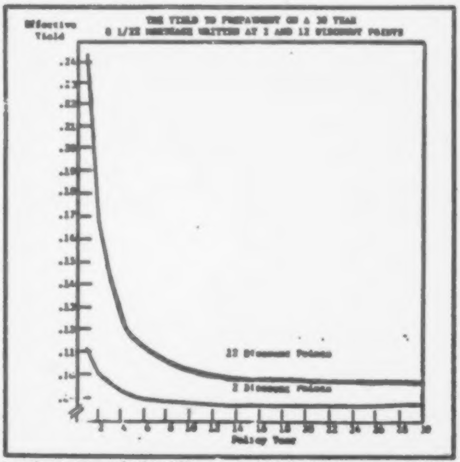
By HELEN FRAME PETERS

Recently, Wall Street has become enamored with a new tool for pricing GNMAs or other mortgage portfolios. Investors are busily calculating the percent FHA so that they can determine their FHA yields. But in their furor to find better ways of pricing their portfolios, investors have been misled by the value of FHA experience and they are likely to find that their FHA Yields are seriously biased estimates of the true yield of their GNMAs or other mortgage-backed portfolios.

The problem is not in the methodology used in Wall Street. All of the mortgage quants thoroughly understand the technical process for calculating the yield on a mortgage portfolio. They correctly have eschewed the 12-year rule of thumb in favor of numbers that they hoped would represent more accurately the prepayment experience of a representative mortgage portfolio. Unfortunately, though, FHA experience, the only numbers available to date, contains errors that few investors understand.

Recent studies now indicate that there are both errors in the data underlying the FHA experience series and even greater problems relating to the way the numbers are put together. In order to get a feel for the seriousness of the issues involved, it is important to understand how mortgage yields are or should be calculated.

To calculate the yield on a mortgage investment, one generally needs to know when the mortgage will terminate, for except for the rare occurrence when a mortgage is acquired at par, the termination date is a crucial ingredient to the rate of return on a mortgage investment.



The earlier the termination date and the lower the price, the higher the yield on a mortgage. As can be seen in the accompanying graph, an 8½%, 30-year mortgage written at 88 will return 23% if it prepays in the first year, versus 9.98% if it runs to maturity. At 98, the difference is less dramatic, but still substantial, at 11% versus 8.72%. and at par, the yield to prepayment equals the contract rate.

Unfortunately, one seldom knows in advance when a mortgage will terminate, thus the exact rate of return cannot be pinpointed. Estimates of the termination date must be used in order to calculate an expected rate of return. For uniformity and simplicity the prevailing method is to use the mortgage market rule of thumb, which prices a 30-year issue as if it prepaid at the 12th policy year. In the 88 and 98, 8½% mortgages, the estimated yield would be 10.34% and 8.78%. Justification for using the rule of thumb comes from an assumption that a 12-year average prepayment period is not that far from reality.

Recent academic studies, though, point out a serious flaw in using the 12-year rule of thumb or any single measure of mortgage life for that matter. They show that using point estimates of mortgage life results in a biased estimate of its expected yield. The relationship between mortgage yield and life is not linear and thus to estimate accurately the yield on a portfolio of mortgages one must estimate the rate of termination for the entire life of the portfolio and calculate the internal rate of return - or realized compound yield if one is concerned with reinvestment rates - for the resultant cash flow.

Wall Street has also taken a close look at the problems with using the 12-year rule of thumb and some firms are now advertising yield tables that are based on a complete distribution of termination (prepayment and default) probabilities. The tables currently in use are a function of a HUD produced set of termination rates known in the business as FHA experience. Most major dealer firms in whole loans, GNMAs or other mortgage securities distribute such yield-tables and some encourage their use in pricing new and seasoned mortgage related instruments. The tables are produced by the Financial Publishing Co., publication No. 715, though they are often distributed under the name of various dealer firms.

> In order to get a feel for the seriousness of the issues involved, it is important to understand how mortgage yields are or should be calculated.

Unfortunately, though, while Wall Street has picked up the right idea - estimating yields with a complete termination distribution — it has also picked up the wrong set of numbers. —FHA experience. Few investors realize that FHA experience presents a highly inaccurate picture of past termination rates and thus has little value as a base for predicting future termination rates.

A very serious technical problem with FHA experience is that in some cases HUD has not recorded accurately the individual prepayment and default data that are used to compile the experience numbers. Several years ago this author acquired the raw FHA data in order to analyze prepayment and default experience of FHA insured residential mortgages. After several months of study it became obvious that there were serious errors on the tape. In several cases, HUD had recorded more mortgage terminations than there were mortgages in the portfolio. A quick scan of the data determined obvious coding errors such as 31 mortgages originated and 226 terminated in the first year.

To determine whether there were other errors in the file, not quite so obvious as the above, further tests were performed to determine whether the rates of prepayment and default over time were consistent with some reasonable guidelines for prepayment and default experience. A total of 25,097 portfolios or 1% of the total data were flagged by the test and sent to HUD for review. Unfortunately, though, HUD does not keep back data files and had no way of checking the data. Recent calls to HUD also have revealed that procedures for recording the data have not changed. Thus the errors found and, more than likely, more recent ones continue to underlie the FHA-experience numbers.

Clearing up such crucial data is obviously a very important step that needs to be taken if investors are to price their mortgage portfolios more accurately. Investors should put pressure on HUD to clean up the data and provide more accurate reports of repayment and default rates of FHA mortgage portfolios. But as HUDs response will obviously take time, investors shold use statistically checked data bases using the methodology described above, in the interim.

Once investors have cleaned-up data bases, the last thing they should do, though, is to use the numbers to generate cleaned-up FHA experience. Errors inherent in the use of FHA experience are far more serious than the errors in the underlying data.

The problem with FHA experience is that instead of being the representative baseline portfolio that it is purported to be, it is a mishmash of experience of many portfolios over very diverse time periods and as such severely misrepresents the standard mortgage experience. A quick look at the accompanying chart will probably explain this point more clearly. FHA experience is a simple average of the mortgage prepayment data available from 1957 to 1976.

The rate of termination for the first year is an average of the first year's rates of prepayment and default of all FHA-203 mortgages written from 1957 to 1976. The second year rate is an average of observations on mortgages written from 1957 to 1975 in their second years. The 1976 portfolio is no longer represented, as data on its second year experience is not yet available. Moving on down, one can see that by the 19th year, the experience is based on data from only two years, 1957 and 1958.

One should not assume from the chart that the problem is with the paucity of observations in the later years; the real problem is what the underlying numbers actually mean in terms of rates of prepayment. As most people are well aware, the rate of prepayment in any year is a function of the rate of interest currently prevailing in the market (if rates go down borrowers will prepay more frequently) other measures of general economic activity, characteristics of the mortgage contract (prepayment penalties and the like) and borrower demographics.

Over the time period behind FHA experience, we have had dramatically different interest rate environments, different norms of borrowers and even changes in the FHA contracts and in the eligibility for insurance. Thus, we are likely to have dramatically different rates of prepayment.

> Few investors realize that FHA experience presents a highly inaccurate picture of past termination rates and thus has little value as a base for predicting future termination rates.

Unfortunately, FHA experience ignores these differences. The rates of prepayment used as the industry standard are first of all averages over very diverse time periods and thus not representative of a particular portfolio. And even more important there is an inherent bias in the numbers as the rates of prepayment in the early years are combinations of portfolios written under a variety of interest rates conditions; whereas, in the later years the data represents the experience of portfolios written when rates were as low as 3%, 4% and 5% and thus are less likely to prepay in our high rate environment. The crucial issue, of course, is not just that this bias exists but what does it mean to the investor who is trying to price a particular portfolio.

If one is pricing a new issue, an investor might try to use some multiple of FHA experience and calculate a FHA yield. Perhaps the investor has been told that a new GNMA 11% will prepay at 250% FHA. But what does this mean in terms of prepayment experience?

If you calculate a FHA yield, you

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Ms. Peters is an assistant vice president in the Securities Investment Department at the Philadelphia Saving Fund Society.

Continued from front page

are saying that your new 11% portfolio will prepay in the first year at a rate 250% faster than the average prepayment experience of portfolios written from 1957 to 1976 in their first year which occurred in 1957 to 1976. For the second year you assume that your portfolio will prepay 250% times faster than the average of how the 1957 portfolio did in 1958, the 1958 portfolio did in 1959, on up to how the 1975 portfolio did in 1976.

By the 21st year, your forecast is that your new 11% will prepay at a rate 250% faster than the 1957 portfolio did in 1976. These are hardly the type of numbers on which one would want to base his estimates of prices and yields for a new portfolio.

> Those who have the appropriate software to produce prices and yields on mortgage portfolios in-house can probably get assistance from securities firms.

If one has a seasoned portfolio the numbers become even more suspect. Consider a five year old pool written in 1975 at 8½%. To price this portfolio using *FHA* experience, one would compare its rates of prepayment to the rates implied by *FHA* experience and estimate the standard multiple. In this case the best estimate might be that the portfolio has paid off at 175% *FHA*.

But delving deeper as we did in the case of the new GNMA, one finds that in this case we are comparing the prepayment experience of the 1975 portfolio in its first year with the average experience of portfolios written from 1957 to 1976. For the fifth policy year, we are comparing the prepayment experience of the 1975 portfolio in 1979 with the average prepayment experience observed from 1961 to 1976 of portfolios written from 1957 to 1972. At this point the reader probably recognizes that these comparisons make little sense. The next question is what can be done to improve the numbers.

Obviously, it would make much more sense to compare a 1975, 8½% portfolio with the experience of its peers - portfolios written in 1975, at 8½% that were written with the same type of borrower characteristics and demographics, and were subject to the same economic conditions and interest rate environment. And if the portfolio prepayed *faster* or *slower* than its peers, then one should be able to take this into account in estimates of future prepayment rates just as one tries to do when estimating percent *FHA*.

Putting together such numbers will, of course, take a concerted effort by many, but it clearly is within reach in the next year or two. The first step is to clean-up the raw *FHA* experience numbers and separate the numbers into appropriate subgroups, such as year of origin of the *FHA* mortgages, contract rate and perhaps even state of origin or other demographics. With these numbers, using appropriate statistical and econometric tools one should be able to forecast the future rate of prepayment of these same pools taking into account past rates of prepayment and estimates of future economic conditions. As an end product of this effort, one should be able to set up tables as simple to use as *FHA* yield but based on numbers with a much greater semblance to reality.

Work in this area is proceeding and in a few years investors should know a lot more about the properties of their GNMAs and other mortgage portfolios; in the meantime, though, GNMAs are, of course, an actively traded item. Dealers generally trade them on a 12-year life which as many have pointed out is highly unrealistic. After reading this article, investors may have a better idea of what is needed to price these issues, but that is of little help for tomorrow's sale. It is frustrating for any investor to know that the answers are coming, but yet not be able to take advantage of the fat yield differentials the market generally gives securities it does not understand.

To fill in the gap for the next year or so, I offer numbers that investors can use to replace *FHA* experience. There are problems in implementing these numbers—though not as serious as with *FHA* experience—and these will be discussed below, but with care and a sharp pencil, the investor should be able to use them to his or her advantage.

The numbers are presented in the accompanying table. Column 1 is comparable to the original *FHA* experience numbers; it is the proportion of the portfolio still outstanding in each policy year since origination. Column 2 is the proportion terminating in each year and is the difference between successive observations in column 1 (note that rounding error may keep this relationship from appearing exact. The numbers were calculated at a much greater precision than is reported there). Column 3 is the termination rate per year and is the proportion terminating in each year divided by the proportion surviving at the end of the previous year.

The difference between the new numbers and *FHA* experience is that the influence of changes in interest rates, other changes in economic activity and changes in the characteristics of borrowers have been removed from the prepayment rate estimate. The techniques for developing the data are available elsewhere for those interested in delving into the theory of prepayment and default distributions and understanding the problems of modeling such. (See for example the author's Ph. D. dissertation "Termination Distributions of *FHA* Insured Residential Mortgages", Wharton School, University of Pennsylvania and "Default and Prepayment Rates of *FHA* Mortgages", Working Paper Series, Federal Reserve Bank of Philadelphia.)

For the purpose of the investor, though, it should suffice to say that what we have here is a baseline portfolio. This is the model's best estimate of how a portfolio written in 1976 would have prepaid if economic and interest rate conditions had remained stable. It obviously is not going to mirror actual experience of 1976 portfolios since the economy and interest experience were far from stable. What it does provide, though, is a benchmark, like its predecessor *FHA* experience against which one can compare the experience of other portfolios and hopefully make somewhat more enlightened projections of the future.

To use these numbers to price an actual portfolio, one would enter them into a computer model just as one does with *FHA* experience and then estimate an adjustment factor. One may feel that a portfolio will prepay at 150% of the base rate, 200% or whatever, depending on the portfolio's past history, the current interest rate environment, one's expectation of future changes and knowledge, if any, of the demographics of the portfolios. The experience many have gained working with *FHA* experience numbers should be directly applicable to using the new set.

Those who do not have the appropriate software to produce prices and yields on mortgage portfolios in-house can probably get assistance from securities firms. Recent discussions with five major houses indicated that all of the firms, though some with more effort than others, could replace *FHA* experience with a customer's own estimate of prepayment experience and generate estimates of prices and yields.

Now, that I have offered a new set of experience numbers, I also should present the caveats in their use. These numbers are still a far cry from what could be put together with a concerted effort by some. The numbers represent a stable interest rate scenario; whereas investors may be concerned with what happens to their portfolio when interest rates rise or fall.

The numbers also are in the aggregate, whereas investors may want to look at specific states or other demographics. Of course, the investor can make some simple adjustments to the numbers and the dealer community can offer some support here, but clearly we are not at the stage yet where we can completely fine tune the pricing of our mortgage portfolios.

The hope is that we are moving ahead, past the 12 year life and *FHA* experience and on to a better method for pricing GNMAs and other mortgage backed securities. ■

MORTGAGE TERMINATION TABLE

Policy Year	Proportion of Mortgages Surviving at Year End	Proportion Terminating In Each Year	Termination Rate Per Year
0.	1.0000		
1.	.962831	.037170	.037170
2.	.907935	.054896	.057015
3	.843069	.064866	.071443
4.	.774140	.068929	.081760
5.	.704348	.069792	.090154
6.	.636358	.067990	.096529
7.	.571615	.064743	.101740
8.	.510203	.061411	.107435
9.	.455144	.055059	.107917
10.	.405601	.049543	.108851
11.	.361016	.044584	.109922
12.	.320854	.040162	.111248
13.	.284737	.036117	.112546
14.	.252063	.032674	.114752
15.	.221757	.030306	.120233
16	.195259	.026498	.119493
17.	.172062	.023196	.118795
18.	.151487	.020575	.119579
19.	.133119	.018368	.121251
20.	.116762	.016357	.122875
21.	.102231	.014531	.124449
22.	.089352	.012879	.125979
23.	.077962	.011390	.127473
24.	.067910	.010052	.128934
25.	.059057	.008853	.130363
26.	.051276	.007781	.131760
27.	.044450	.006826	.133129
28.	.038472	.005977	.134473
29.	.033248	.005224	.135796
30.	.000000	.033248	1.000000

SEASONING OF FHA-EXPERIENCE

By Age of the portfolios, years in which they were written and the calendar years in which they were observed.

Age*	Origination Years	Observation* Years	Number of Yearly Observations
1	1957-1976	1957-1976	20
2	1957-1975	1958-1976	19
3	1957-1974	1959-1976	18
4	1957-1973	1960-1976	17
5	1957-1972	1961-1976	16
6	1957-1971	1962-1976	15
7	1957-1970	1963-1976	14
8	1957-1969	1964-1976	13
9	1957-1968	1965-1976	12
10	1957-1967	1966-1976	11
11	1957-1966	1967-1976	10
12	1957-1965	1968-1976	9
13	1957-1964	1969-1976	8
14	1957-1963	1970-1976	7
15	1957-1962	1971-1976	6
16	1957-1961	1972-1976	5
17	1957-1960	1973-1976	4
18	1957-1959	1974-1976	3
19	1957-1958	1975-1976	2
20	1957	1976	1
21-30	Forecasted data points		0

*The origination year plus the age of the portfolio minus one equals the observation year. For example, a portfolio written in 1957 will be five years old in 1961.

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But delving deeper as we did in the case of the new GNMA, one finds that in this case we are comparing the prepayment experience of the 1975 portfolio in its first year with the average experience of portfolios written from 1957 to 1976. For the fifth policy year, we are comparing the prepayment experience of the 1975 portfolio in 1979 with the average prepayment experience observed from 1961 to 1976 of portfolios written from 1957 to 1972. At this point the reader probably recognizes that these comparisons make little sense. The next question is what can be done to improve the numbers.

Obviously, it would make much more sense to compare a 1975, 8¼% portfolio with the experience of its peers - portfolios written in 1975, at 8¼% that were written with the same type of borrower characterics and demographics, and were subject to the same economic conditions and interest rate environment. And if the portfolio prepayed faster or slower than its peers, then one should be able to take this into account in estimates of future prepayment rates just as one tries to do when estimating percent FHA.

Putting together such numbers will, of course, take a concerted effort by many, but it clearly is within reach in the next year or two. The first step is to clean-up the raw FHA experience numbers and separate the numbers into appropriate subgroups, such as year of origin of the FHA mortgages, contract rate and perhaps even state of origin or other demographics. With these numbers, using appropriate statistical and econometric tools one should be able to forecast the future rate of prepayment of these same pools taking into account part rates of prepayment and estimates of future economic conditions. As an end product of this effort, one should be able to set up tables as simple to use as FHA yield but based on numbers with a much greater semblance to reality.

Work in this area is proceeding and in a few years investors should know a lot more about the properties of their GNMAs and other mortgage portfolios; in the meantime, though, GNMAs are, of course, an actively traded item. Dealers generally trade them on a 12-year life which as many have pointed out is highly unrealistic. After reading this article, investors may have a better idea of what is needed to price these issues, but that is of little help for tomorrow's sale. It is frustrating for any investor to know that the answers are coming, but yet not be able to take advantage of the fat yield differentials the market generally gives securities it does not understand.

To fill in the gap for the next year or so, I offer numbers that investors can use to replace FHA experience. There are problems in implementing these numbers—though not as serious as with FHA experience—and these will be discussed below, but with care and a sharp pencil, the investor should be able to use them to his or her advantage.

The numbers are presented in the accompanying table. Column 1 is comparable to the original FHA experience numbers; it is the proportion of the portfolio still outstanding in each policy year since origination. Column 2 is the proportion terminating in each year and is the difference between successive observations in column 1 (note that rounding error may keep this relationship from appearing exact. The numbers were calculated at a much greater precision than is reported there). Column 3 is the termination rate per year and is the proportion terminating in each year divided by the proportion surviving at the end of the previous year.

The difference between the new numbers and FHA experience is that the influence of changes in interest rates, other changes in economic activity and changes in the characteristics of borrowers have been removed from the prepayment rate estimate. The techniques for developing the data are available elsewhere for those interested in delving into the theory of prepayment and default distributions and understanding the problems of modeling each. (See for example the author's Ph. D. dissertation "Termination Distributions of FHA Insured Residential Mortgages", Wharton School, University of Pennsylvania and "Default and Prepayment Rates of FHA Mortgages", Working Paper Series, Federal Reserve Bank of Philadelphia.)

For the purpose of the investor, though, it should suffice to say that what we have here is a baseline portfolio. This is the model's best estimate of how a portfolio written in 1975 would have prepaid if economic and interest rate conditions had remained stable. It obviously is not going to mirror actual experience of 1976 portfolios since the economy and interest experience were far from stable. What it does provide, though, is a benchmark, like its predecessor FHA experience against which one can compare the experience of other portfolios and hopefully make somewhat more enlightened projections of the future.

To use these numbers to price an actual portfolio, one would enter them into a computer model just as one does with FHA experience and then estimate an adjustment factor. One may feel that a portfolio will prepay at 150% of the base rate, 200% or whatever, depending on the portfolio's past history, the current interest rate environment, one's expectation of future changes and knowledge, if any, of the demographics of the portfolios. The experience many have gained working with FHA experience numbers should be directly applicable to using the new set.

Those who do not have the appropriate software to produce prices and yields on mortgage portfolios in-house can probably get assistance from securities firms. Recent discussions with five major houses indicated that all of the firms, though some with more effort than others, could replace FHA experience with a customer's own estimate of prepayment experience and generate estimates of prices and yields.

Now, that I have offered a new set of experience numbers, I also should present the caveats in their use. These numbers are still a *far cry* from what could be put together with a concerted effort by some. The numbers represent a stable interest rate scenario; whereas investors may be concerned with what happens to their portfolio when interest rates rise or fall.

The numbers also are in the aggregate, whereas investors may want to look at specific states or other demographics. Of course, the investor can make some simple adjustments to the numbers and the dealer community can offer some support here, but clearly we are not at the stage yet where we can completely fine tune the pricing of our mortgage portfolios.

The hope is that we are moving ahead, past the 12 year life and FHA experience and on to a better method for pricing GNMAs and other mortgage backed securities. ■

MORTGAGE TERMINATION TABLE

Policy Year	Proportion of Mortgages Surviving at Year End	Proportion Terminating In Each Year	Termination Rate Per Year
0.	1.000000		
1.	.962830	.037170	.037170
2.	.907935	.054896	.057015
3	.843069	.064866	.071443
4.	.774140	.068929	.081760
5.	.704348	.069792	.090154
6.	.636358	.067990	.096529
7.	.571615	.064743	.101740
8.	.510203	.061411	.107435
9.	.455144	.055059	.107917
10.	.405601	.049543	.108851
11.	.361016	.044584	.109922
12.	.320854	.040162	.111248
13.	.284737	.036117	.112566
14.	.252063	.032674	.114752
15.	.221757	.030306	.120233
16	.195258	.026498	.119493
17.	.172062	.023196	.118795
18.	.151487	.020575	.119579
19.	.133119	.018368	.121251
20.	.116762	.016357	.122875
21.	.102231	.014531	.124449
22.	.089352	.012879	.125979
23.	.077962	.011390	.127473
24.	.067910	.010052	.129934
25.	.059057	.008853	.130363
26.	.051276	.007781	.131760
27.	.044450	.006826	.133129
28.	.038472	.005977	.134473
29.	.033248	.005224	.135796
30.	.000000	.033248	1.000000

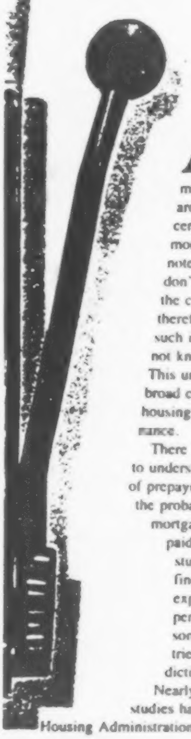
SEASONING OF FHA-EXPERIENCE

By Age of the portfolios, years in which they were written and the calendar years in which they were observed.

Age*	Origination Years	Observation* Years	Number of Yearly Observations
1	1957-1976	1957-1976	20
2	1957-1975	1958-1976	19
3	1957-1974	1959-1976	18
4	1957-1973	1960-1976	17
5	1957-1972	1961-1976	16
6	1957-1971	1962-1976	15
7	1957-1970	1963-1976	14
8	1957-1969	1964-1976	13
9	1957-1968	1965-1976	12
10	1957-1967	1966-1976	11
11	1957-1966	1967-1976	10
12	1957-1965	1968-1976	9
13	1957-1964	1969-1976	8
14	1957-1963	1970-1976	7
15	1957-1962	1971-1976	6
16	1957-1961	1972-1976	5
17	1957-1960	1973-1976	4
18	1957-1959	1974-1976	3
19	1957-1958	1975-1976	2
20	1957	1976	1
21-30	Forecasted data points		0

*The origination year plus the age of the portfolio minus one equals the observation year. For example, a portfolio written in 1957 will be five years old in 1961.

Many studies have sought to understand the patterns of mortgagor prepayment. Under contract to Freddie Mac, Merrill Lynch's Mortgage-Backed Securities Research Department studied the prepayment rates of Freddie Mac's portfolio of conventional mortgages, covering the years 1973 to 1980. The results of the study are released in SMM *for the first time. This article, the second of two, describes an econometric model that relates prepayment experience to a variety of mortgagor characteristics and economic conditions.*



A portfolio manager's decisions about mortgage investment are colored by uncertainty. Some mortgagors pay their notes early, and some don't pay them at all, the cash flows and, therefore, the return on such investments are not known in advance. This uncertainty has broad consequences for housing and housing finance.

There have been efforts to understand the patterns of prepayment, to assess the probability that a mortgage will be prepaid. Many such studies have confined themselves to explaining past experience, although some have also tried to develop predictive models.

Nearly all of these studies have used Federal Housing Administration (FHA) loan data, but FHA mortgages are different from conventional mortgages. The Freddie Mac mortgage portfolio does contain conventional loans, however, and Merrill Lynch's Mortgage-Backed Securities Research Department (under contract to Freddie Mac) has conducted a study of prepayment experience with the portfolio (see "Prepayment Patterns of Conventional Mortgages," *SMM*, February 1984). Much of the work of the study centered on building an econometric model of prepayments that would explain past events and also have predictive value.

A model can be based on data about individual mortgages; information about each loan in a portfolio can be used to construct an equation that accounts for the principal influences on prepayment, and the results of all of the individual loan experiences can be combined to give an accurate picture of past experience. But a model of this kind is of limited value—there is not much use for an equation that forecasts whether an individual borrower will prepay. To be useful in calculating prepayment rates for mortgage pools, the predictions about prepayment of individual mortgages in each pool must be aggregated, and this may be costly. Another technique, the one chosen for this study, is to aggregate the individual mortgages into groups or cohorts based on common characteristics and to calculate prepayment probabilities for the whole group.[1] The result is a model that explains the proportion of mortgages that have been prepaid in each cohort; properly constructed, the model is also valuable for making predictions. Obviously, the choice of characteristics by which data are classified is critical to the success of this method.

Some mortgagors pay their notes early, and some don't pay them at all, making returns uncertain.

The classification variables employed to aggregate the Freddie Mac data into cohorts were origination year, geographic region, and interest rate class. Origination year was chosen as a classification variable because prepayment rates were known to vary for otherwise similar mortgages that were originated in different years. The characteristics of both mortgage instruments and mortgage holders are determined, to a great extent, by the economic conditions at origination. The effect of origination year on prepayment rates was expected to be pronounced for the Freddie Mac portfolio because interest rates were very volatile from 1973 to 1980, the years for which data were available for the study.

Geographic region was chosen because the origination of mortgages is still essentially a local or regional activity. A number of factors can cause differences in prepayment rates between regions, including variations in the flow of funds to the institutions that make mortgage loans, differences in state regulation of interest rates, and regional variations in loan demand.

Interest rate class, the third classification variable, was chosen for somewhat more complex reasons. Many factors affect contract rate, including the borrower's creditworthiness; a loan that is thought to be relatively risky may carry a higher interest rate than one thought secure, or may not be made at all. This affects the composition of the group of borrowers whose loans are at a given rate. Mortgagors who get loans at the same time but at different rates are likely to be different kinds of borrowers with different likelihoods of prepayment. After an extensive examination of the Freddie Mac data, the loans were grouped by interest rate classes (with intervals of 50 basis points). This aggregation resulted in 1,358 data classes. Cohorts representing fewer than 100 mortgage originations then were eliminated, leaving 921 cohorts of more than 100 loans each in the final database.

> ***When new financing is cheap, prepayment rates rise; when it is expensive, they drop.***

Why Borrowers Prepay

The probability that the mortgages in any group will be prepaid ultimately rests on individual decisions. Young borrowers with growing families, for example, might prepay a mortgage as they move from a smaller house to a larger one. Income and wealth also affect the likelihood of prepayment. However, although these variables can be important to any one mortgagor's decision to prepay, when the mortgages are taken as a group, the single strongest factor behind prepayment rates is the cost of financing. When new financing is cheap, prepayment rates rise; when it is expensive, they drop.

Another important financial factor is the ratio of the remaining principal balance of a mortgage to the amount of money that can be borrowed against the property. If that ratio is large, the loan is still attractive; if the ratio is small, the borrower may decide to refinance. Prepayment rates also vary by region and by the age of the mortgage. Even quite broad factors—such as general economic conditions and population migration—have discernible effects. Moreover, changes in any of these variables can change others.

The Merrill Lynch prepayment model incorporates all of these elements, defining variables for market value, financing costs, mortgage age, borrower's income, borrower's age, and borrower's wealth; changes in economic conditions, population movement, and location are also taken into account.

Effects of Individual Variables

The most important influence, the cost of financing, seems straightforward: prepayments rise as new financing costs fall. Specifying the relationship is not simple, because the decision to prepay depends on both the size of the difference between market and contract rates and the level of the contract rate. Moreover, because of the fixed costs of moving or of refinancing an old mortgage, borrowers are likely to be more responsive to a big drop in current mortgage rates than to a small drop or an increase. To allow for this, the model uses two variables to represent the effect of changing mortgage rates. One is RATECNG (for rate change), defined as the percentage difference between the current mortgage rate and the contract rate. But if the current mortgage rate is greater than the contract rate or not more than 5 percent smaller, the probability of prepayment is calculated by adding the effect of a second variable SMLADJ (for small adjustment) to the effect of RATECNG. Because the two coefficients are determined independently, the model allows changes in the probability of prepayment to differ, depending on whether the rates are rising or falling and whether the difference is large or small.

The Model

An ordinary least squares regression was used to test various model specifications. The one chosen as a best estimate for the Freddie Mac portfolio is:

$$\mathrm{CPR}_{jt} = \underset{(-5.72)}{-\,0.07372\ \mathrm{AVAIL}_{jt}} - \underset{(-1.97)}{1.79927\ \mathrm{POINTS}_t} - \underset{(-10.89)}{0.53727\ \mathrm{RATECNG}_j}$$

$$+ \underset{(7.68)}{0.39199\ \mathrm{SMLADJ}_j} + \sum_{k=1}^{8} d_k\ \mathrm{POLYR}_k + \underset{(4.36)}{0.04092\ \mathrm{EARNS}_j} - \underset{(-3.08)}{0.00146\ \mathrm{AGEBORR}_j}$$

$$+ \underset{(5.01)}{0.01803\ \mathrm{WEALTH}_j} + \underset{(7.58)}{0.00215\ \mathrm{MIGRN}_t}$$

$$+ \underset{(6.16)}{0.61480\ \mathrm{GNP}_t} - \underset{(-6.95)}{0.02618\ \mathrm{SE}_j} - \underset{(-3.93)}{0.01827\ \mathrm{WEST}_j}$$

d_k = 0.01548; 0.05116; 0.09234; 0.12304; 0.12968; 0.12968; 0.12968; 0.12968;

$R^2 = 0.850$; $\bar{R}^2 = 0.847$; $F_{(18,910)} = 469.22$; SSE = 1.152; the number of observations = 921; and the numbers in parentheses under the coefficients are t-statistics;

where:

CPR_{jt} = the conditional prepayment rate in year t for cohort j;
AVAIL_{jt} = the ratio of the mean principal balance or assumption value of the mortgages in the cohort to the mean borrowing potential in the market;
POINTS_t = buyer discount points in year t (in percent);
$\mathrm{RATECNG}_j$ = for cohort j, the difference between the market mortgage rate in year t and the contract rate on the mortgages expressed as a percentage of the contract rate;
SMLADJ_j = zero if RATECNG is less than −5 percent, otherwise equals RATECNG;
POLYR_k = a variable taking the value zero except in the k^{th} year of the cohort's lifetime, when it takes the value one;
EARNS_j = the mean monthly household earnings of the primary borrower (in thousands of dollars) for all borrowers in cohort j;
$\mathrm{AGEBORR}_j$ = the mean age of all primary borrowers in cohort j;
WEALTH_j = the ratio of the mean number of bedrooms in the house to mean number of dependents for all home owners in cohort j;
MIGRN_t = net migration per thousand of population in year t;
GNP_t = the percentage change in the real gross national product (in 1972 dollars) in year t; and
SE_j, WEST_j = dummy variables equal to one if the region of origination for mortgages in cohort j is Southeast or West, respectively; zero otherwise.

The model also incorporates the effects of other elements of financing costs: buyer discount points, which make new financing more expensive and so tend to lower prepayment rates, and the ratio of the mortgage balance to the property value. But the variables that explain prepayments are not all financial; some borrower characteristics—principally earnings, age, and wealth—are also associated with prepayment. (Earnings and wealth are positively associated with prepayment; age, negatively.) Data on earnings and age at origination appear in the Freddie Mac database, but data on wealth do not. The model uses the ratio of the mean number of bedrooms to dependents in each cohort to represent a pure wealth variable; a high ratio is associated with affluence, which is associated with higher prepayment rates. Other ways of representing wealth—number of bathrooms, years on the job, and expense-to-income ratios, for example—were tried, but only this definition performed well in the model.

The likelihood that a mortgage will be prepaid in the first year or two is not very high; most borrowers' circumstances do not change that rapidly. After that, however, prepayment rates do rise until the "duration in residence" effect—the borrower's preference for remaining where he or she is—comes into play. The policy year variable, POLYR, expresses these effects of mortgage aging on prepayment rates.[2]

Finally, each borrower's decision to prepay may well rest on a change in personal economic circumstances that the Freddie Mac data cannot trace. To represent these effects, the model uses two macroeconomic variables, one based on the gross national product (GNP) and one on population movement. Change in real GNP and migration figures both are positively corre-

How It Works

To demonstrate how the model works, assume that one is trying to predict the conditional prepayment rate in 1984 (the sixth policy year) for mortgages originated in 1979 at a rate of 10 percent in the Northeast. Assume further that the explanatory variables have the following values:

$\mathrm{AVAIL}_{jt} = 0.697$ $\mathrm{AGEBORR}_j = 33.5$ years
$\mathrm{POINTS}_t = 0.02$ $\mathrm{WEALTH}_j = 2.31$
$\mathrm{RATECNG}_j = 0.274$ $\mathrm{MIGRN}_t = 3.85$
$\mathrm{SMLADJ}_j = 0.274$ $\mathrm{GNP}_t = 0.42$
$\mathrm{POLYR}_k = 0.12968$, because 1984 is the sixth policy year ($k = 6$); and
$\mathrm{ERNS}_j = \$1.81555$ (monthly earnings = \$1815.55).

Because the mortgages were originated in the Northeast, the effect of the dummy variables SE_j and WEST_j is nil (they equal zero).

The equation predicts a conditional prepayment rate of:

$$\begin{aligned} \mathrm{CPR} = {} & (-0.07372 \times 0.697) - (1.79927 \times 0.02) - (0.53727 \times 0.274) \\ & + (0.39199 \times 0.274) + (1 \times 0.12968) + (0.04092 \times 1.81555) \\ & - (0.00146 \times 33.5) + (0.01803 \times 2.31) + (0.00215 \times 3.85) \\ & + (0.6148 \times 0.042) \\ = {} & 0.1036 \end{aligned}$$

In other words, a conditional prepayment rate of 10.36 percent is expected for this cohort of mortgages.

If the number of discount points were increased from 2 to 3, the value of this variable would be −0.054 (−1.79927 × 0.03) instead of −0.036 (−1.79927 × 0.02), a difference of −0.018 or −1.8 percent. In this case, the predicted prepayment rate would fall from 10.36 percent to 8.56 percent.

lated with higher prepayment rates. When people are better off financially and optimistic about their future prospects, they are more likely to prepay, either because of a move to a more expensive house or because of a change to a better job. The GNP variable reflects this. Migration is a direct measure of mobility. When more people are moving, an increase in prepayments is expected. Other macroeconomic variables were tried—among them, the unemployment rate, housing starts, and the consumer price index—but none had as significant an effect on prepayment rates.

Some unexplained variation in prepayment rates remained after the effects of these ten variables were taken into account. This variation could be caused by differences in economic conditions from one region of the country to another, or by differences in state statutes, or by regional differences in mortgage lending practices. To express this, dummy variables—set at one if the mortgages in the cohort were originated in the West or Southeast, at zero otherwise—were included.

The Results

The estimated equation succeeds in explaining much of the prepayment experience of the Freddie Mac portfolio. It captures approximately 85 percent of the variation in conditional prepayment rates and includes all the factors thought to be important. The explanatory variables are statistically significant, and each affects the conditional prepayment rate in the expected direction.

The variables are not equally important, however. Taken as a group, the cost of financing variables (AVAIL, POINTS, RATECNG, and SMLADJ) have the most significant impact. The cost of financing is negatively correlated with prepayments; that is, prepayments rise (fall) as the cost of mortgage finance decreases (increases). The RATECNG and SMLADJ variables are of particular importance. As expected, borrowers' responses to a relative change in interest rates are not symmetric; prepayment rates increase faster when mortgage rates fall by more than 5 percent than they decrease when market rates rise. Investors and other market participants should recognize this differential impact.

The ratio of the mortgage balance to property value is apparently less important than the other cost-of-financing variables, most probably because of the difficulty in measuring accurately the value of the mortgage relative to the value of the property. Although the principal balance can be computed at any time, the value of the property and of options associated with the existing mortgage are not as easy to calculate.

Of the other variables, policy year, percentage change in real GNP, and borrower earnings are the most important, and they are all easily measured. Policy year captures the effect of the aging, or seasoning, of a mortgage. Prepayment rates should rise, peak, and then level off. This is observed for the Freddie Mac data until the interest rate effects begin to distort the pattern in the later years. The GNP variable serves to capture general economic well-being (as expected, borrowers prepay more frequently when they are better off financially) and the same is true for borrower earnings. However, there are two key distinctions between GNP and borrower earnings as employed in the model. First, the GNP variable is a broad, nationwide variable, but the earnings variable is measured only for borrowers whose mortgages are in the Freddie Mac portfolio. Second, GNP is measured after origination, while borrower earnings are captured only at origination. It would be helpful to use a variable that measures borrowers' earnings over time, but such data were not available.

Although the other variables—borrower age, wealth, migration, and the regional dummy variables—all are conceptually important and statistically significant, and affect prepayment rates in the expected direction, they are not as important in explaining the data or in predicting future prepayment rates. For the borrower age variable, this is because the data showed relatively little variation in borrowers' ages. The other variables do not have a similarly powerful effect on the model because they represent qualitative effects that are difficult to measure with precision.

Prepayment rates increase faster when mortgage rates fall by more than 5 percent than they decrease when market rates rise.

Conclusion

The significant structural changes that have occurred in financial markets in the 1980s will affect the way in which any model estimated with data from an earlier time will perform. Additional research using current data would, therefore, be of great value. Still, the prepayment model developed for this study is a step toward a fuller understanding of the factors that determine the way borrowers prepay on conventional mortgages.

Notes

1. This study of prepayment calculated conditional probabilities. "Conditional" means that the probability is calculated on the basis of the number of mortgages left in the portfolio after terminations from previous periods. The unconditional probabilities of prepayment would be calculated using the number of mortgages originally in the portfolio.

2. If the Freddie Mac database covered a long enough period of time, prepayment rates would be expected to increase in the early policy years, before leveling off in the later years. However, the nature of the data is such that the effect of the high and increasing level of interest rates observed in 1979 and 1980 dominates the policy year effect in the later years. (See "Prepayment Patterns of Conventional Mortgages," SMM, February 1984, for a description of this relationship.) To account for this problem, the model sets the coefficients of the policy year variables for policy years six through eight at the value obtained in the fifth policy year.

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Mortgagors can prepay their loans at any time. The simplicity of this statement conceals its real effect: the investor in a mortgage or mortgage security cannot be certain of when, or in what amounts, his or her investment will be returned. This uncertainty increases the cost of housing finance. Higher financing costs have implications, not only for investors in mortgages and mortgage-backed securities, but also for all members of the mortgage and allied industries, including construction.

Better information on mortgage prepayments can reduce uncertainty—but surprisingly little is available. The U.S. Department of Housing and Urban Development does publish statistics on prepayments of Federal Housing Administration mortgages, but similar data have not been available for conventional mortgages and mortgage securities. To remedy this, the Merrill Lynch Mortgage-Backed Securities Research Department (under contract to Freddie Mac) completed a study of the prepayment and default experience of the Freddie Mac conventional mortgage portfolio.[1]

The *Average Weighted Life Study*, as the Merrill Lynch effort is known, analyzed data from approximately 503,000 conventional fixed-rate mortgages, originated between 1973 and 1980, that applied to one- to four-family owner-occupied houses. (No comparable data were available prior to 1973.) Freddie Mac's mortgage portfolio is uniquely suited to a study of prepayments because it is the single largest portfolio of conventional mortgages in the United States and the mortgages are drawn from all regions of the country. The main deficiency is that all mortgages are relatively new—the oldest mortgages that could be included in this study were purchased in 1973. Because the data ended in 1980, it was not possible to study the effects of the high interest rates of the early 1980s on prepayment rates, nor to chart any changes in prepayments as interest rates began to fall. Within these limits, the study does offer a unique portrait of conventional mortgage prepayments in the recent past and some guidelines for projecting possible rates and timing of prepayments in the future.

Measuring Prepayment Rates

Many factors can influence a borrower's willingness and ability to pay off a mortgage early—he or she may receive an inheritance, face a change in family size, or suddenly need to relocate. More significantly, prepayments often reflect fundamental mortgagor characteristics and economic conditions, particularly those related to interest rates. Over a whole portfolio, it is possible to associate variations in prepayment rates with such characteristics and conditions, thereby uncovering patterns potentially useful to investors.

> *Prepayments often reflect fundamental mortgagor characteristics and economic conditions, particularly those related to interest rates.*

The most useful statistic for making this association is the conditional probability of prepayment (or conditional prepayment rate), defined as the ratio of the number of mortgages that are prepaid in a given period to the total number of mortgages in the portfolio at the beginning of the period. (The qualifier "conditional" refers to the fact that the probability is conditional on the number left in the portfolio after terminations from previous periods. The unconditional probability of prepayment would be calculated using the number of mortgages originally in the portfolio.) The conditional probability is useful because it connects that rate with a particular period of time, and therefore to a particular set of economic conditions.

The conditional probabilities of prepayment, derived from the Freddie Mac mortgage portfolio and expressed as percentages, can be linked with several measures of time. One such measure is by year of origination—the year in which the mortgage originates. The economic conditions existing that year—unusually high interest rates, for example—will ordinarily affect the terms of the mortgage and the types of borrowers receiving loans, and thus the decisions later made by mortgagors. A second measure is by policy year—how old the mortgage is. Mortgagors' incomes and housing needs change over time; relating prepayment rates to policy year can uncover, for example, any tendency of mortgagors to pay off after 5, 10, or 15 years. The third measure is by calendar year. This can be used simply, in the traditional manner, to chart changes in overall rates of prepayment from year to year. By itself, this measure has serious deficiencies, but data grouped both by calendar year and by year of origination or policy year can be used to yield a more accurate picture of prepayment rates under various conditions.

The Freddie Mac Prepayment Experience

Conditional prepayment rates for the Freddie Mac portfolio of conventional mortgages, classified by year of origination and policy year, are shown in table 1.[2] The average interest rates (weighted by volume) for the mortgages written each year are also given.

Variations in prepayment rates according to the age of a mortgage can be seen by reading down the columns of table 1. In the period studied, prepayments rose rapidly to a peak in the early years and then declined quickly; this pattern holds for all years of origination (except 1979 and 1980, for which there are too few years of data to show the pattern). Mortgages that originated in or before 1976 have prepayment records with peaks between 12.7 percent and 15.5 percent—rates higher than those for Federal Housing Administration

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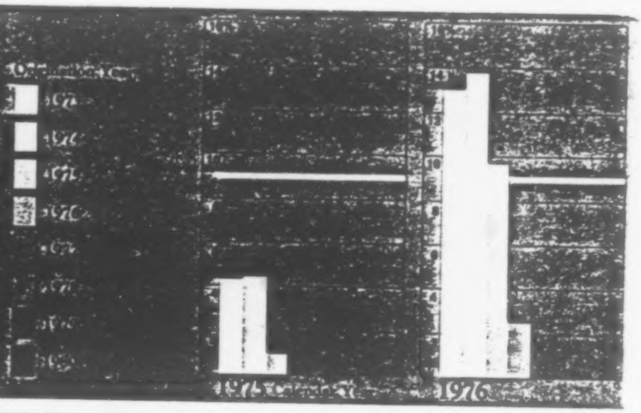
[1] In this study, loans that had been foreclosed were considered to be in default.

[2] The Freddie Mac portfolio contains mortgages written in 1973 and 1974, but data on termination activity prior to 1975 were not available. Thus, the 1973 and 1974 originations still in the database are only a subset of the mortgages bought by Freddie Mac that originated in those years. For this reason, table 2 begins in 1975.

Figure 2

Conditional Probabilities of Prepayment by Origination and Calendar Years



Default Patterns

The Merrill Lynch study of the Freddie Mac portfolio included a look at default rates on conventional mortgages originated between 1973 and 1980. For these calendar years, the conditional probability (see story for definition) of default over the whole portfolio ranged from 0.03 percent in 1980 to a high of 0.10 percent in 1977. However, such annual default rates are not the most useful. The state of the economy affects mortgages originated at different times in different ways; and mortgage aging has a significant effect on defaults (a mortgagor's equity generally increases over time, making default increasingly unattractive). The study, therefore, classified the default data by origination year and by policy year (see table A).

Mortgages that originated before 1979 show a common pattern of default rates: they are low in the beginning, rise to a peak, and then decline rather quickly. Those originating in 1976, 1977, and 1978 have much lower default rates, perhaps because of the rapid growth in house prices that occurred in those years. Default rates also vary by policy year and year of origination: for example, default rates were highest in the fourth policy year for 1974, 1975, and 1976 originations, but peaked in the fifth policy year for 1973 originations.

Variations in default rates by calendar year can be read from table A by following the diagonals that go down and to the left (for example, calendar year 1977 is represented by 1977 originations in the first policy year (0.002 percent), 1976 originations in their second policy year (0.020 percent), and so on). The highest default rates overall are in 1977 and 1978; the lowest are in 1980. These figures suggest the effect of current economic conditions on mortgagors' decisions to default.

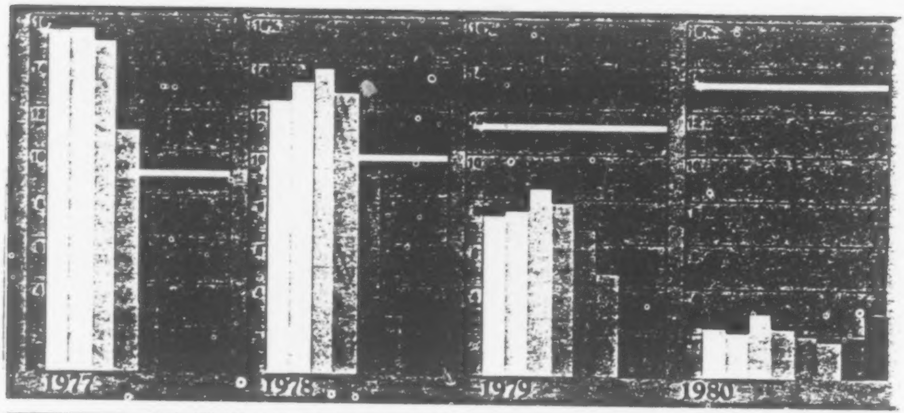
The number of defaults (approximately 1,000, or 0.2 percent) is very small relative to the number of mortgages in the portfolio. If only a handful of mortgages more or less were to default in a given period, the probability of default would change significantly (although the number would still be relatively small). Any conclusions suggested by these statistics must therefore be extremely tentative.

Table A

Conditional Probabilities of Default by Origination and Policy Years

Policy Year	Conditional Probability of Default (Percent)							
	Year of Origination							
	1973	1974	1975	1976	1977	1978	1979	1980
1	N.A.	N.A.	0.005	0.000	0.002	0.011	0.021	0.000
2	N.A.	0.082	0.032	0.020	0.055	0.061	0.056	
3	0.048	0.166	0.142	0.048	0.059	0.030		
4	0.121	0.259	0.161	0.056	0.020			
5	0.195	0.185	0.102	0.018				
6	0.098	0.083	0.025					
7	0.006	0.023						
8	0.007							
Mean Mortgage Contract Rate	8.3	8.9	9.0	9.0	9.0	9.8	11.2	13.1

Note: N.A. = Not available.



The interaction between year of origination and calendar year is shown more clearly in figure 2. Prepayment rates for mortgages originated in 1973, 1974, and 1975 reached a peak in calendar year 1977. The mortgages originated in 1974 experienced the highest rates of prepayment until 1977; thereafter, the highest rates of prepayment are associated with mortgages originated in 1975. After 1977, mortgages originating in 1973 experienced the sharpest decline in prepayment rates. Those mortgages originated when interest rates were relatively low and thus give mortgagors the greatest incentive to avoid prepaying their mortgages.

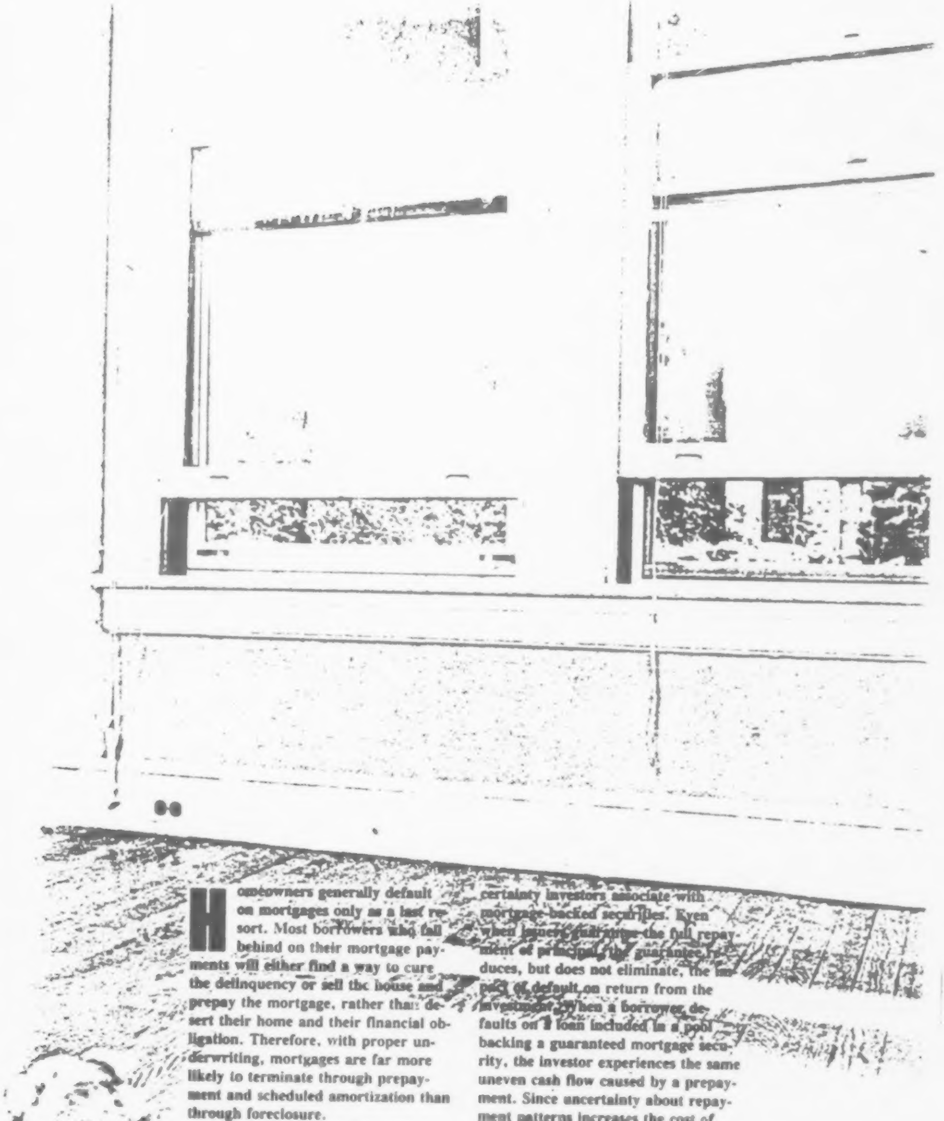
Prepayments of mortgages originated in 1976 and 1977 were highest in 1978. Mortgagors who borrowed in 1976 prepaid faster, on the average, in all calendar years (although the rate of decline in prepayment probability is greater for these mortgages as interest rates increased in later years). Because the difference in the mean contract rate between 1976 and 1977 mortgages is small, the variations in prepayment rates are largely attributable to the mortgage aging effect and to differences in other mortgage and borrower characteristics that are not shown here. The prepayment experience for mortgages originated in 1979 and 1980 is dominated by the interest rate cycle. To some extent, this is true for 1978 originations. However, with three policy years of prepayment experience available, there is also evidence of other prepayment influences from economic conditions.

Summary

The basic statistics for prepayment rates on conventional mortgage loans purchased by Freddie Mac from 1973 to 1980 can be useful to the secondary markets. To the extent that they reduce uncertainty, these figures can make investment in mortgages more attractive. The statistics shown in this article allow inferences about how mortgagor characteristics and economic conditions influence prepayment, but cannot describe those influences with any precision. More precise information can be derived from an econometric model of mortgage prepayments. Such a model, developed as part of the *Average Weighted Life Study*, will be presented in the next issue of *Secondary Mortgage Markets*.

To the extent that they reduce uncertainty, these figures can make investment in mortgages more attractive.

Helen F. Peters is vice president and group manager for the Debt Strategy Group, Merrill Lynch Pierce Fenner & Smith Inc., New York, where Scott M. Pinkus is vice president and manager of the Mortgage-Backed Securities Research Department. David J. Askin was a financial economist for Merrill Lynch's Mortgage-Backed Securities Research Department when the research reported in this article was conducted. He is now a senior analyst for the Bank and Finance Department of Moody's Investors Service.



Homeowners generally default on mortgages only as a last resort. Most borrowers who fall behind on their mortgage payments will either find a way to cure the delinquency or sell the house and prepay the mortgage, rather than desert their home and their financial obligation. Therefore, with proper underwriting, mortgages are far more likely to terminate through prepayment and scheduled amortization than through foreclosure.

Although default on fixed-rate mortgages is relatively uncommon, the possibility contributes to the uncertainty investors associate with mortgage-backed securities. Even when issuers guarantee the full repayment of principal, the guarantee reduces, but does not eliminate, the impact of default on return from the investment. When a borrower defaults on a loan included in a pool backing a guaranteed mortgage security, the investor experiences the same uneven cash flow caused by a prepayment. Since uncertainty about repayment patterns increases the cost of housing finance, the ability to predict when default may occur could help lower mortgage rates.

Conducting the Research

The analysis of defaults relies on the same data base as the prepayment study (see "Figuring the Odds," *Secondary Mortgage Markets*, May 1984): approximately 503,000 conventional fixed-rate mortgages on 1-4 family owner-occupied houses. Lenders in all regions of the United States originated the loans from 1973 to 1980 and sold them to Freddie Mac. Only 0.2 percent, or approximately 1,000, of the loans in the sample ended in default during the period studied.

The study grouped the mortgages into cohorts by region and by year of origination and then examined the default experience of each cohort in successive years. This method is similar to the analysis of prepayment experience, except that prepayment cohorts were based on interest rates as well as region and origination year. Default occurred too

The Model

Ordinary least squares regression was used to estimate the default model. The model developed for the Freddie Mac portfolio is:

$$\begin{aligned}
\mathrm{CDR}_{jt} = {} & \underset{(1.77)}{0.00281}\ \mathrm{LTP}_{jt} - \underset{(-2.57)}{0.00048}\ \mathrm{YJOB}_j + \underset{(2.18)}{0.01583}\ \mathrm{SECMTG}_j \\
& + \underset{(2.14)}{0.03321}\ \mathrm{EXP/INC}_j + \underset{(5.11)}{0.00002}\ \mathrm{CREDIT}_t - \underset{(-3.82)}{0.00013}\ \mathrm{MIGRN}_t - \underset{(-2.21)}{0.000004}\ \mathrm{GNP72}_t \\
& + \underset{(5.60)}{0.00139}\ \mathrm{NE}_j + \underset{(5.22)}{0.00222}\ \mathrm{SE}_j + \underset{(2.95)}{0.00116}\ \mathrm{SW}_j + \underset{(2.93)}{0.00166}\ \mathrm{WEST}_j \\
& - \underset{(-5.86)}{0.00215}\ \mathrm{POLYR1} - \underset{(-4.23)}{0.00131}\ \mathrm{POLYR2} - \underset{(-2.97)}{0.00075}\ \mathrm{POLYR3}
\end{aligned}$$

$R^2 = 0.6114$; $\bar{R}^2 = 0.585$; $F_{(13,189)} = 21.46$; $SSE = 0.0002$;

the number of observations = 205; and the numbers in parentheses under the coefficients are t-statistics;

where:

CDR_{jt} = the conditional default rate for cohort j in year t;

LTP_{jt} = the ratio of the remaining principal balance to the estimated current sales price of the house for cohort j in year t;

YJOB_j = the number of years the primary borrower has held the current job for cohort j;

SECMTG_j = the proportion of mortgages using secondary financing at the time of origination for cohort j;

$\mathrm{EXP/INC}_j$ = the ratio of total monthly housing expenses to total monthly income for cohort j;

CREDIT_t = the net change in consumer credit outstanding at time t;

MIGRN_t = the net migration per thousand of population in year t;

$\mathrm{GNP72}_t$ = the level of real gross national product in 1972 dollars in year t;

NE_j, SE_j, SW_j, WEST_j = dummy variables equal to one if the region of origination for mortgages in cohort j is Northeast, Southeast, Southwest or West; zero otherwise; and

POLYR1, POLYR2, POLYR3 = dummy variables for the first three policy years in a cohort's lifetime. For example, POLYR1 is equal to one in the first year and zero for the other years.

infrequently to permit stratifying the ata by interest rates, because the cohorts created would have had few defaults, if any, in most of the years udied.

There are several ways to measure the ault experience of a cohort. This dy used the conditional probability of ault: that is, the number of mortes that default in a given period npared with the total number of rtgages in the portfolio at the beging of the period. The unconditional bability, an alternative measure, uld be calculated based on the numof mortgages originally in the portio. Conditional probability is more ful because it ties the default rate to articular time period and therefore to articular set of economic conditions.

Characteristics of individual borrowand mortgages as well as the econic environment each year should afct the default experience of each rtgage cohort. Financial analysis and evious studies of default imply that e net equity borrowers would receive om the sale of a home is the primary fluence on the decision to default. If orrowers can sell the home for more han the outstanding loan balance plus elling costs, they are likely to do so and prepay the loan, rather than default. This implies that information on the loan-to-value ratio is needed for each mortgage every year. Unfortunately, only the original loan-to-value ratio was available in the data base. For later years, the ratio was estimated by adjusting the loan balance for normal amortization and the original property value by a price index for housing.

The study included four other characteristics of individual borrowers and loans. First, the use of second mortgages to help finance the purchase was important to consider because mortgagors with second loans have less equity in the property and greater monthly payments to make. Second, the age of the loan was included because borrowers are able to predict their financial circumstances reasonably well for the first few years of the loan and are likely to avoid taking loans they cannot manage. This implies that default rates may be lower during the initial years than later. The tendency is partially offset by the low level of equity borrowers accumulate, through amortization or appreciation, during the early years of a mortgage and by changes in borrowers' economic conditions. Therefore, default rates may rise in the early years and level off as equity increases. Third, the number of years the primary borrower has held the current job was included because a stable employment history should lead to a continuous and growing stream of income to support borrower

How It Works

An investor could use the model to predict the conditional default rate in 1984 for mortgages originated in the Northeast in 1979 by assigning the following values to the explanatory variables:

LTP_{jt} = 0.509
$YJOB_j$ = 5.07 years
$SECMTG_j$ = 0.041
EXP/INC_j = 0.25
$CREDIT_t$ = \$28.7 billion
$MIGRN_t$ = 3.852 million
$GNP72_t$ = \$1602.485 billion
NE_j = 1.0

Since the mortgages were originated in the Northeast, the other regional variables, SE_j, SW_j, and $West_j$, need not be considered. Similarly, since the default forecast is for the sixth policy year, the variables that apply to the first three policy years, POLYR1, POLYR2, and POLYR3, have no effect.

With these parameter values, the model forecasts a conditional default rate of:

$$\begin{aligned} \mathbf{CDR} &= (0.00281 \times 0.509) - (0.00048 \times 5.07) + (0.01583 \times 0.041) \\ &\quad + (0.03321 \times 0.25) + (0.00002 \times 28.7) - (0.00013 \times 3.852) \\ &\quad - (0.000004 \times 1602.485) + (0.00139 \times 1.0) \\ &= 0.003001 \end{aligned}$$

In other words, a conditional default rate of 0.30 percent is expected for this cohort of mortgages.

If the expense-to-income ratio were increased from 25 percent to 30 percent, the value of this variable would be 0.00996 (0.03321 × 0.30) instead of 0.00830 (0.03321 × 0.25), a difference of 0.0016 or 0.166 percent. In this case, the predicted default rate would increase from 0.30 percent to 0.466 percent.

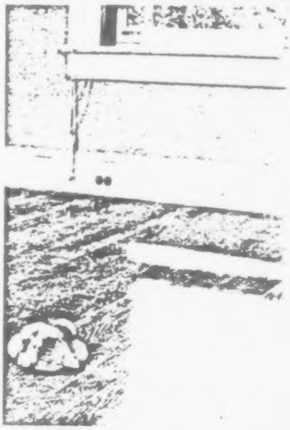
obligations. Finally, the ratio of housing expense to income was included because the higher the ratio, the less disposable income the borrower has available to meet adverse conditions, which may arise in the future. This increases the likelihood of default.

Since the model developed in this study applies to cohorts, the variables describing individual borrowers and loans are converted to average figures for the cohort. These include, for example, the proportion of mortgages with secondary financing and the average ratio of the loan balance to the estimated sales price.

General economic conditions influence default rates as well. High real gross national product indicates a strong economy. When the nation is prosperous, borrowers are less likely to encounter financial difficulties that would reduce their ability to make monthly payments. If they do become delinquent, they can probably sell the home quickly at a profit, enabling them to prepay, rather than default on the mortgage. National migration rates are included for two reasons. High migration rates are another way of representing a strong economy since people are more likely to move in prosperous times. Also, when people move frequently, delinquent borrowers more readily find buyers for their homes. In contrast, large amounts of consumer credit outstanding may increase default rates. Mortgagors with large debts will find it difficult to meet their financial obligations.

Effects of Individual Variables

The statistical analysis of the Freddie Mac data base found that all mortgagor and economic characteristics affected default rates as expected. For example, default rates are unusually low in the first three years of a mortgage, but they gradually increase during that period and level off beginning in the fourth year. Borrowers with a stable employment history are less likely to default, and borrowers who used a second mortgage to help purchase the house are more likely to default. Default rates are higher for cohorts with a high ratio of housing expenses to income.



The default rate is higher for cohorts with a high ratio of loan balance to estimated house price. The relatively small magnitude of the impact of loan balance to home price may, at first glance, be surprising, since most discussions of default emphasize the importance of loan-to-value ratios. However, there are several possible explanations for this result. One is that there may not be enough variability in the data to statistically measure the true impact of loan-to-value ratios. Lenders may have maintained more than adequate loan-to-value coverage in recent years. Thus, although the variable may still be a prime determinant of defaults, its impact may not be measurable in today's markets. A second reason may be the presence of the variable for secondary financing. The loan balance portion of the loan balance to house price ratio reflects only the principal amount on the first mortgage. If secondary financing exists, the loan balance to house price variable overstates the cohort's true net equity position. Another explanation may be that the actual values of the houses were not available each year. Instead, the values were based on the original price adjusted by a price index for later years. This procedure would overestimate the prices of houses on which default was most likely because of inadequate maintenance or lower than normal appreciation.

The general economic variables imply that default is lower during prosperous years when GNP and migration rates are high. High volume of consumer credit is associated with increased default rates. The four dummy variables for regions imply that when other factors are equal, default rates are lower in the North Central and California regions (the omitted variables) and higher in the Southeast than in the rest of the United States.

Evaluation

The estimated equation accounts for more than half of the variation in default rates by cohort in the Freddie Mac portfolio. The individual variables are statistically significant and affect default rates in the directions expected. The model is an improvement over previous attempts to explain default that relied entirely on national or regional macroeconomic variables, such as GNP or unemployment rates. Such models cannot show how mortgage or mortgagor characteristics affect default. In particular, they cannot show how borrowers react to the financial incentives to default (see "Mortgages à la Carte," p. 12). This default model can combine macroeconomic variables, readily available in many forecasts, with information on specific groups of borrowers, so that default rates can be predicted for a specific pool of mortgages based on an expected economic scenario.

Re-estimating the model to include the default experience since 1980 of the loans in the data base would be useful. A more fundamental requirement for better default predictions is a way of monitoring changes in the economic and demographic circumstances of borrowers after loans are originated.

Lenders and investors will find the ability to apply an accurate default model to mortgages under current conditions valuable, especially with the proliferation of ARMs and other alternative mortgage instruments.

Helen F. Peters is vice president and group manager of the Debt Strategy Group of Merrill Lynch Pierce Fenner & Smith Inc. Scott M. Pinkus is manager of the Mortgage-Backed Securities Research Department at Morgan Stanley & Co. David J. Askin is vice president of Mortgage-Backed Securities for Drexel Burnham Lambert Inc. Mr. Pinkus was vice president and manager and Mr. Askin was a financial economist for Merrill Lynch's Mortgage-Backed Securities Research Department when the research reported in this article was conducted.

Senator **Chafee**. I was interested in page 7 of your testimony, when you say—and I am going to ask the others whether they agree with this or whether this seems overly optimistic—you say: The quarter-point reduction of interest rates could result in as many as 30,000 new housing starts per year. According to the Economics Division of the National Association of Home Builders, the construction of 30,000 single family homes generates 52,000 man-years of employment and nearly $1 billion in wages. Those are astonishing statistics. Do others agree? Mr. Wise?

Mr. **Wise**. Mr. Chairman, I don't think the projections are unreasonable, assuming you get that kind of a reduction; but our view is that the reduction in interest rate consumers has largely occurred already by the activity that is in the marketplace now. And any further reduction seems to us to be unlikely.

Senator **Chafee**. Mr. Lasko?

Mr. **Lasko**. Historically, the rule of thumb has been that a 1-percent reduction in interest rates—mortgage rates across the board—roughly correlates with a 100,000 unit increase in housing starts per year. And so, the figure is roughly appropriate in that regard; it may be a little on the high side, but a quarter percent reduction in rates would give you about 25,000 additional starts, if that cut in rates applied across the entire marketplace.

Senator **Chafee**. Mr. Harkins?

Mr. **Harkins**. I did not bring statistics with me, Mr. Chairman, but I would agree with the comment Mr. Lasko made and also indicate that, of course, in this period qualifying for mortgages has become more difficult as lenders and insurers have imposed new restrictions. Therefore, any additional assistance that can be brought to bear in the form of a lower overall interest rate will help offset some of the impact of those more stringent qualifications.

Senator **Chafee**. Mr. Weber?

Mr. **Weber**. Mr. Chairman, clearly the steepness of the yield curve today would indicate that the securitization of mortgages will result in some significant decline in interest rates on the mortgages being originated. How that converts into housing starts, I really don't know.

Senator **Chafee**. Do you members of this panel believe that, in permitting the securitization of other assets—other than mortgage-backed assets—it would affect the area you are interested in?

Mr. **Weber**. It wouldn't affect it.

Senator **Chafee**. Mr. Harkins?

Mr. **Harkins**. Mr. Chairman, I think we would generally prefer the bill being limited to mortgage-backed securities. Mortgages and, of course, the houses that are underlying those mortgages represent the largest single investment that most Americans make. And clearly, the kind of credit impact on individuals is far greater than it is through any other type of borrowing. That is not to say they shouldn't have relief across the board. There is also the consideration of security.

Mortgage-backed securities are a proven product in the marketplace. Of that, there is no debate. Other types of assets-based securities are less certain. They are new; they are relatively new to the scene, and I think until they are better understood in the marketplace, it would represent a definite competitive impact on the ability to generate mortgage credit.

Senator CHAFEE. Mr. Lasko?

Mr. LASKO. We naturally represent mortgage lenders and are here certainly to urge that home mortgages as well as commercial be included; but we don't oppose the inclusion of all assets. I think we are fundamentally in favor of competition and efficiency and new technology; and it would be difficult to impose at least at some point in time, using the devices we are talking about, throughout the capital market.

Senator CHAFEE. Mr. Wise?

Mr. WISE. Our institutions invest the overwhelming majority of their funds in home mortgages, but they also are allowed to invest a limited portion of their assets——

Senator CHAFEE. I wouldn't ask so much from whether you would avail yourself of it, but whether this would set as a competitive force that would reduce the flow of income, of moneys, into the areas you are interested in.

Mr. WISE. To the extent that it would do that—and I think to some extent it would—we are concerned about that. Yes.

Senator CHAFEE. Ms. Peters?

Ms. PETERS. On behalf of Security Pacific Bank, the more assets that are available and asset types to manage the interest rate risk that one has in terms of asset and liability management, the more secure the bank and the banking industry as a whole will be. From the side of pension funds and other purchasers of assets, the more broad variety of securities that are available to them that meet some of their particular asset and liability needs, the more aggressive they will be in putting their funds into the marketplace.

Mr. WEBER. The National Council of Thrifts really has not taken a position on the use of other assets for the securitization process, and I——

Senator CHAFEE. Well, don't let that slow you down. [Laughter.]

Mr. WEBER. Well, philosophically, I have no objection to it, assuming that the benefits would be the same to the public from the securitization of other assets as it is mortgage-backed loans.

Senator CHAFEE. All right. Now, we can see the banks are in support of this legislation. We have a telegram here from Citibank and others; and some of the S&L's do not. Why couldn't the S&L's use these mortgage-backed securities?

Mr. WISE. The fact is that a major segment of our institutions are heavy investors in these kinds of securities, but traditionally, our institutions have invested their funds in loans and held them to maturity. And to the extent that the portfolio—an institution is a portfolio lender—these kinds of securities present some special problems for that kind of an institution, particularly one who is interested in originating adjustable rate mortgages as a means of achieving the asset liability objectives that Ms. Peters commented on. So, that is the major concern.

As I mentioned in my comments, our industry is in a bit of a transition on this issue; and it depends on the institution's particular objectives as to where they come down on your question.

Senator **Chafee**. It seems to me you are making really a pitch for the variable rate mortgages, and you like that spread. And the testimony is that this will reduce that spread.

Mr. **Wise**. I am not necessarily making a pitch for adjustable rate mortgages. They have, of course, been a valuable tool both for our institutions and the restructuring process, achieving asset liability management objectives and eliminating the interest rate risk that was inherent in our portfolios; they have also been valuable for consumers as well because at certain stages of the rate cycle, the adjustable rate mortgage is a very desirable tool. And to the extent that increasing use of securitization reduces the availability or the marketability of adjustable rate mortgages, I don't think that is a consumer benefit. I think it is a consumer detriment.

Senator **Chafee**. I am not sure I agree. I don't think that if you come down in the fixed rate mortgages, and reduce the spread, that it is harmful to the variable rate mortgage.

Mr. **Wise**. My only point, Mr. Chairman, is that increasing use of these securitized fixed rate mortgages may reduce the availability in some rate cycles, some positions of the rate cycle, of the adjustable rate mortgage, a tool which has not only been useful for institutions but one that has been quite useful for consumers.

Senator **Chafee**. Let me ask you this. As you know, my bill doesn't use the grantor trust vehicle. Do you have any problems if we don't use the grantor trust approach? Treasury didn't seem to like the grantor trust. What do you think? Mr. Harkins?

Mr. **Harkins**. I don't want to make a technical comment on it, Mr. Chairman. I think we would prefer your approach; we think it is cleaner. It clearly identifies a new class of securities and eliminates all confusion or complication that arises from trying to cover them under the grantor trust provisions; and I think probably on balance our organization would feel that that is the more appropriate route to follow, although I think the point to be made is not so much which way you go as the fact that you go one way or the other to achieve the objective. That is the important thrust from our viewpoint.

Senator **Chafee**. Ms. Peters? Any views? It is not required to state any if you don't have any.

Ms. **Peters**. I think it has been said.

Senator **Chafee**. Mr. Weber?

Mr. **Weber**. Clearly, the simplest approach is the best, and I am not enough of a tax person to know the differences, but key issue, I think, is to make the income taxable to the investor and follow the cash flow as much as possible.

Senator **Chafee**. Mr. Lasko?

Mr. **Lasko**. I think we would hope for a marriage of the two approaches at some point. I will say the easier course is the grantor trust approach. It is a fairly simple modification, but that bill doesn't do as yours does and get into the clarification of all the OID tax rules, which I think is essential. We might as well go the whole mile. So, I think I am saying ultimately a marriage of the two bills is called for. We don,t have a strong view on whether you set up a separate tax approach, like your bill does, or the grantor trust, although one view—and I guess I personally hold it—is that the simpler approach from that standpoint alone is the grantor trust approach. Just clarify that.

Senator CHAFEE. Mr. Wise?

Mr. WISE. I agree with Mr. Lasko; to the extent that your bill clarifies the OID problem, it is very important to us.

Senator CHAFEE. I didn't specifically ask about what you anticipated the decline in interest would be if this legislation were to pass. Now, Mr. Harkins, I think, said between 50 and 89 basis points. Was that your testimony?

Mr. HARKINS. Well, I indicated that our analysis had shown a range of benefit on CMO securities, anywhere from 29 to 89 basis points; and I think it is very clear because of the similarity between a CMS or that kind of security and a CMO that there would be a likelihood of that type of benefit.

Senator CHAFEE. I guess Mr. Wise thought that the juice was already out of it.

Mr. WISE. That is correct.

Senator CHAFEE. Because of the extensive use of them already.

Mr. WISE. That is correct.

Senator CHAFEE. All right. Thank you very much for coming here. If there are any questions submitted to you, we would appreciate it if you got them back in a short time.

The next panel consists of Mr. Brown, Ms. Kiernan, Ms. Campbell, Mr. Sellers, Ms. Babcock, and Ms. Caplan. If you would all move right up, please; and would those folks who are leaving please do so quietly.

My final comment to the past panels is that this word "securitize," it seems to me, is a further degrading of the English language. [Laughter.]

Senator CHAFEE. Everything becomes a verb. All right. Mr. Brown?

STATEMENT OF WILLIAM Y. BROWN, DIRECTOR OF MARINE AFFAIRS, WASTE MANAGEMENT, INC., WASHINGTON, DC

Mr. BROWN. Mr. Chairman, my name is Bill Brown. I am director of marine affairs at Waste Management, Inc. I am a biologist and lawyer by training. I joined Waste Management this past year after 3½ years with the Environmental Defense Fund. Before that, I served for 5 years with the Federal Endangered Species Program.

My statement is given in support of S. 1839. That bill incorporates the heart of a report and model legislation published by the Environmental Defense Fund. Important natural ecosystems are being degraded in the United States and abroad. Several hundred thousand acres of wetlands are lost each year in the United States. About 80 percent of the loss is attributable to agriculture. Much of the remainder is linked to urban development. Wild rivers have become rare, and extinction of species continues.

The Federal budget deficit has spawned draconian measures for control of spending. The Gramm-Rudman legislation is poised to force budget cuts that will limit funds for acquisition of key natural ecosystems. All programs for ecosystem conservation are in danger of reduction or elimination. As never before, we must identify and implement policies that both protect the environment and do not require Government spending. S. 1839 goes a step farther. It would actually save money while helping to protect key natural areas. S. 1839 is a conservative bill. The bill would simply implement a purer form of tax reform for key environmental zones. These zones are areas of ecological importance and has already been identified under Federal law but which have not been protected from potentially harmful activities that tax expenditures may encourage.

Consider an endangered plant species. Federal agencies may not authorize funds or carry out activities that destroy or adversely modify the critical habitat of a plant. If no Federal permit or funds are involved, however, a shopping center can be built on top of the plant's habitat and the usual tax credits and deductions may be claimed on the taxpayer's Federal income tax return. Senators, the bill would not control private activities on designated lands, as the Treasury Department representative stated. The bill simply removes tax subsidies for development of areas that our Government has determined should be protected.

As Senator Chafee has stated, S. 1839 simply says to the developer: Proceed if you wish, but you will get no encouragement from the Federal Government in the way of tax breaks. Is not that the least we can do as a nation? President Reagan has spoken of amending the Tax Code to encourage development of economically depressed inner city corridors—the enterprise zones. S. 1839 is the complement to that policy. But it will save the Treasury's money rather than to spend it. I urge you to secure passage of this bill. The New Deal has been played, and the Great Society has gone home. The environment can profit from our national metamorphosis, just as it can be harmed. S. 1839 is a gold mine for the environment.

And Senator, it is also a new idea; and I guess I applaud that. I don't think there is any other legislation that I am aware of that a Member of Congress on either side has introduced to close tax loopholes that lead to the development of natural areas. Thank you.

Senator CHAFEE. Thank you, Mr. Brown. We have to be very cautious of new ideas, you know. They are rather dangerous sometimes. [Laughter.]

All right. Ms. Kiernan.

[The prepared statement of Mr. Brown follows:]

STATEMENT OF DR. WILLIAM Y. BROWN
DIRECTOR OF MARINE AFFAIRS
WASTE MANAGEMENT, INC.

HEARING ON S. 1839

BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

MY NAME IS BILL BROWN. I AM DIRECTOR OF MARINE AFFAIRS OF WASTE MANAGEMENT, INC.[1] I AM A BIOLOGIST AND LAWYER BY TRAINING. I JOINED WASTE MANAGEMENT IN THIS PAST YEAR AFTER THREE AND A HALF YEARS WITH THE ENVIRONMENTAL DEFENSE FUND; BEFORE THAT I SERVED FOR FIVE YEARS WITH THE FEDERAL ENDANGERED SPECIES PROGRAM. MY STATEMENT IS GIVEN IN

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[1] Waste Management, Inc. is the world's largest manager of solid and hazardous waste, with operations throughout the United States and in South America, Australia, and Saudi Arabia. The company's stock is traded on the New York Stock Exchange.

SUPPORT OF S. 1839.[2] THE BILL INCORPORATES THE HEART OF A REPORT AND MODEL LEGISLATION PUBLISHED BY THE ENVIRONMENTAL DEFENSE FUND.[3]

IMPORTANT NATURAL ECOSYSTEMS ARE BEING DEGRADED IN THE UNITED STATES AND ABROAD. SEVERAL HUNDRED THOUSAND ACRES OF WETLANDS ARE LOST EACH YEAR IN THE UNITED STATES. ABOUT 80 PERCENT OF THE LOSS IS ATTRIBUTABLE TO AGRICULTURE; MUCH OF THE REMAINDER IS LINKED TO URBAN DEVELOPMENT.[4] WILD RIVERS HAVE BECOME RARE, AND EXTINCTION OF SPECIES CONTINUES.

THE FEDERAL BUDGET DEFICIT HAS SPAWNED DRACONIAN MEASURES FOR CONTROL OF SPENDING. THE GRAMM-RUDMAN LEGISLATION IS POISED TO FORCE BUDGET CUT-BACKS THAT WILL LIMIT FUNDS FOR ACQUISITION OF KEY NATURAL ECOSYSTEMS. ALL PROGRAMS FOR ECOSYSTEM CONSERVATION ARE IN DANGER OF REDUCTION OR ELIMINATION.

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[2] This statement is given on behalf of Waste Management, Inc. and the Center for Environmental Education ("CEE"). Established in 1972, CEE has received support from more than 500,000 individuals for the organization's efforts to protect and to secure enlightened use of the ocean and its marine life.

[3] A copy of the EDF report, excluding model legislation, has been provided with this statement for inclusion in the record.

[4] Wetlands: Their Use and Regulation (Washington, D.C.: U.S. Congress Office of Technology Assessment, OTA-0-206, March 1984). Pp. 87-114.

AS NEVER BEFORE, WE MUST IDENTIFY AND IMPLEMENT POLICIES THAT BOTH PROTECT THE ENVIRONMENT AND DO NOT REQUIRE GOVERNMENT SPENDING. S. 1839 GOES A STEP FURTHER--IT WOULD ACTUALLY SAVE MONEY WHILE HELPING TO PROTECT KEY NATURAL AREAS.

S. 1839 IS A CONSERVATIVE BILL. THE BILL WOULD SIMPLY IMPLEMENT A PURER FORM OF TAX REFORM FOR KEY ENVIRONMENTAL ZONES. THESE ZONES ARE AREAS WHOSE ECOLOGICAL IMPORTANCE HAS ALREADY BEEN IDENTIFIED UNDER FEDERAL LAW BUT WHICH HAVE NOT BEEN PROTECTED FROM POTENTIALLY HARMFUL ACTIVITIES THAT TAX EXPENDITURES MAY ENCOURAGE.

CONSIDER AN ENDANGERED PLANT SPECIES. FEDERAL AGENCIES MAY NOT AUTHORIZE, FUND, OR CARRY OUT ACTIVITIES THAT DESTROY OR ADVERSELY MODIFY THE CRITICAL HABITAT OF THE PLANT. IF NO FEDERAL PERMIT OR FUNDS ARE INVOLVED, HOWEVER, A SHOPPING CENTER CAN BE BUILT ON TOP OF THE PLANT'S HABITAT AND THE USUAL TAX CREDITS AND DEDUCTIONS MAY BE CLAIMED ON THE TAXPAYER'S FEDERAL INCOME TAX RETURN. AS SENATOR CHAFEE HAS STATED, S. 1839 SAYS TO THE DEVELOPER: "PROCEED IF YOU WISH, BUT YOU WILL GET NO ENCOURAGEMENT FROM THE FEDERAL GOVERNMENT IN THE WAY OF TAX BREAKS." IS NOT THAT THE LEAST WE CAN DO AS A NATION?

PRESIDENT REAGAN HAS SPOKEN OF AMENDING THE TAX CODE TO ENCOURAGE DEVELOPMENT OF ECONOMICALLY DEPRESSED INNER CITY CORES. S. 1839 IS THE COMPLEMENT TO THAT POLICY, BUT WILL SAVE THE TREASURY'S MONEY RATHER THAN SPEND IT.

I URGE YOU TO SECURE PASSAGE OF THIS BILL. THE NEW DEAL HAS BEEN PLAYED AND THE GREAT SOCIETY HAS GONE HOME. THE ENVIRONMENT CAN PROFIT FROM OUR NATIONAL METAMORPHOSIS JUST AS IT CAN BE HARMED. S. 1839 IS A GOLD MINE.

ENVIRONMENTAL DEFENSE FUND

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ELIMINATING TAX SUBSIDIES TO PROTECT CRITICAL HABITAT FOR ENDANGERED SPECIES AND OTHER NATURAL AREAS

A REPORT

AND

MODEL LEGISLATION

PREPARED BY WILLIAM Y. BROWN
ENVIRONMENTAL DEFENSE FUND

February 4, 1985

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INTRODUCTION

This report, including the model legislation set forth in pages 33 through 35, was prepared to facilitate potential congressional action eliminating tax expenditures that subsidize activities causing harm in specific "designated natural areas" of ecological significance.

Important natural ecosystems are being degraded in many areas of the United States and elsewhere in the world. Several hundred thousand acres of wetlands are lost each year in the United States. About 80 percent of the loss is attributable to agriculture, and much of the remainder is linked to urban development.[1] Estimates of loss of tropical forests, for example, range from 6 million to 50 million acres per year. As for wetlands in the United States, agriculture, often in the form of cattle ranching and forestry, is the leading immediate cause of ecological degradation.[2]

Some measure of the loss of key natural ecosystems is attributable to activities underwritten by tax credits and deductions. The Office of Technology Assessment, for example, has concluded that "[t]ax deductions and credits for all types

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1. Wetlands: Their Use and Regulation (Washington, D.C.: U.S. Congress Office of Technology Assessment, OTA-O-206, March 1984). Pp. 87-114

2. See, e.g., Proceedings of the U.S. Strategy Conference on Tropical Deforestation. June 12-14, 1978, Washington, D.C. Sponsored by the U.S. Dept. of State and U.S. Agency for International Development.

of general development activities provide the most significant Federal incentive for farmers to clear and drain wetlands."[3]

The amendment to the Internal Revenue Code (Title 26 of the United States Code; "Code") contained in the model legislation of this report would generate additional federal revenues and thus contribute to reduction of the federal deficit. No new tax is proposed; investment tax credit and certain deductions would be disallowed.

The model legislation is selective in choice of Code provisions for revision. No limitation would be imposed on existing ordinary deductions for the cost of producing net income (e.g., Code §162), including provision for recovery of capital expenditures through depreciation (§167) and cost depletion allowances (§612). No amendments are proposed that would limit deduction of interest (§163) or state and local taxes (§164). Instead, the model legislation would limit availability of tax credits--direct forms of tax subsidy whose enactment was premised upon the belief that promotion of particular activities considered is in the public interest. The model legislation would prevent use of these credits when activities promoted by them turn against the public interest because of harm caused to designated natural areas.

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[3] _Supra_ note 1 at 12.

The model legislation also would amend the Code to disallow certain extraordinary deductions of expenditures paid or incurred in carrying on these same harmful activities. The deductions affected are described in some detail below. In general, these currently allow expensing of amounts paid or incurred that otherwise would be added to the taxpayer's basis in real property; would be deducted over several years as depreciation; or would allow accelerated multi-year recovery of depreciable capital expenditures. Such Code provisions are special interest exceptions to the basic concepts and implementing statutory provisions of tax policy.

The model legislation would also disallow deduction of foreign taxes if paid in carrying out harmful activities within designated natural areas. Deduction of state and local taxes would be unaffected.

The designated natural areas to which the model legislation would apply may occur within or outside of the United States. Each of the ten categories of designated natural areas set forth in Section 2 defines areas of extraordinary ecological significance. Properties in seven categories (subsections A-G) are limited to the United States; properties in three categories (subsections H-J) may occur in any country that is party to the underlying convention. Category (K) is limited to areas beyond the territory of the United States.

The designated natural areas covered by the legislation exclude lands held in federal ownership. Federal lands are already subject to management standards providing some degree of ecosystem conservation.

The international categories of designated natural areas would for the first time redress the frequent lament of conservationists that enterprises conducting business in the United States are engaged in activities destructive to ecosystems outside our borders. By limiting subsidies for the destructive activities of U.S. taxpayers, the model legislation would assist the nations in which such areas occur to protect key ecosystems whose international protection these nations will generally have worked to secure.

The additional federal revenues that would follow enactment of the model legislation are unknown, but an upper limit presumably could be calculated by the Treasury Department on the basis of credits and deductions previously claimed under the affected sections of the Code. It may be possible to roughly estimate the fraction of these funds at stake by analysing a sample of returns filed under these sections on the basis of location and nature of activities involved.

Since this report was first drafted, the Treasury Department has issued Volumes 1 and 2 of a Report to the President on Tax Reform for Fairness, Simplicity, and Economic Growth (November 1984). With the exception of provisions on foreign taxes, the Treasury proposals would repeal or greatly limit each of the provisions addressed in this report and model legislation. Provisions that the model legislation would negate in well defined, key ecosystems, the Treasury proposals would eliminate entirely.

In general, we applaud the Treasury Department for many proposals that would benefit the environment and reduce the federal budget deficit. Most of the proposals concerning extraction of mineral resources, for example, are of this kind.

The relative environmental values of the Treasury proposals and this model legislation depend upon the scope of natural areas protected by the latter and the importance placed upon them. By creating a tax differential, the system contemplated by this report should benefit designated natural areas far more than general removal of tax subsidies contained in the Treasury proposals. On the other hand, designated natural areas would constitute only a small fraction of all ecosystems affected by these tax expenditures.

Neither the President, the incoming Treasury Secretary James Baker or the Congress have embraced the Treasury Department proposals. They are referenced in this report where particularly appropriate, but are not addressed at length.

SECTION-BY-SECTION ANALYSIS
OF THE DRAFT LEGISLATION

SECTION 1. DEFINITION OF DESIGNATED AREAS

This section defines ten kinds of areas that would be treated as designated natural areas under the model legislation and would receive protection from harmful tax subsidies. Federal property is excluded from coverage. Property owned privately or by state or local governments is covered by the model legislation's amendment to the Code if located within any of the ten categories enumerated.

Tax incentives for donation or sale of interests in the same first four categories of properties (subsections A-D) to conservation organizations were proposed in H.R. 5900 during the 98th Congress. A hearing was held on the H.R. 5900 by the House Subcommittee on Fisheries and Wildlife Conservation and the Environment.

The latter four international categories (subsections G-J) are included to reach the extraterritorial activities of persons subject to U.S. tax laws, e.g., a company incorporated in the United States that produces cattle in Latin America and transports beef to the United States. No areas within the United States other than federal properties have been designated under any of these international categories.

Critical Habitat of Endangered or Threatened Species

Areas would qualify under subsection A if located within critical habitat of endangered species. Such areas contain physical or biological features that the Secretary of the Interior, or the Secretary of Commerce for marine organisms, has determined to be essential for the conservation of a species listed as threatened, or endangered pursuant to the Endangered Species Act of 1973, 16 U.S.C. 1531 *et seq*. Descriptions and maps of such areas are published in Title 50 of the Code of Federal Regulations at Parts 17 and 226. Federal agencies are enjoined under the Endangered Species Act from authorizing, funding, or carrying out any action that adversely modifies the critical habitat of an endangered or threatened species.

Additions to the Wildlife Refuge and Park Systems

Subsection B authorizes protection under the model legislation for areas officially designated for acquisition for inclusion within the National Wildlife Refuge System or the National Park System. Congress has identified protection of such areas in these familiar, key federal systems for the conservation of nature as a priority, awaiting only specific appropriation of funds.

Coastal Barrier Resources

The Coastal Barrier Resources System consists of certain, mapped, undeveloped coastal barrier islands located on the

Atlantic and Gulf coasts of the United States (16 U.S.C. 3503). New federal expenditures or new financial assistance is barred for specified development activities occuring within this system. 16 U.S.C. 3504, 3504. Tax subsidies, however, are not limited by these provisions, and the model legislation would extend to tax expenditures the limits on appropriated federal subsidies contained in the barrier islands legislation. The Interior Department is preparing a report to Congress on tax subsidies harmful to these islands, and proposals in that report should also be considered.

National Natural Landmarks

The Department of the Interior maintains a National Registry of Natural Landmarks under the authority of the Historic Sites Act of 1935, 16 U.S.C. 461-467. As of September 30, 1983, 594 areas were included in the Registry, each chosen because it was found to contain ecological or geological features that are nationally significant examples of the nation's natural heritage.[4] No federal regulatory or management standards are invoked by designation as a landmark. An owner who enters into an agreement with the National Park Service to protect the landmark is eligible to receive a certificate, and a bronze plaque may be presented to the owner for appropriate display on the site. All landmarks in the Registry are located in the United States, including its territories. Some one-half of the landmarks are administered soley by federal, state, or local government agencies, one-third are entirely privately owned, and the remainder are owned or administered by a mixture of public agencies and private individuals.

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[4] *See* 48 Fed. Reg. 8681-8714 (1983); 49 Fed. Reg. 4605 (1984).

Wild and Scenic Study Rivers

The Secretary of the Interior or of Agriculture, as appropriate, is required to study and report to the President on rivers designated by Congress for potential addition to the wild and scenic rivers system. 16 U.S.C. 1275. For three years after Congress designates a river for study, the Federal Power Commission is barred from licensing the construction of a dam or other project works on the river, and all federal agencies are enjoined from assisting in the construction of any water resources project that would have "a direct and adverse effect on the values for which such river might be designated . . ." 16 U.S.C. 1278(b). No limits, however, are placed on federal tax subsidies for damaging private investment.

Ecosystems Contiguous to National Parks

On March 20, 1984, Senator John Chafee introduced the Wildlife and Parks Act of 1984. Title IV of S.978. The purpose of this bill is to protect fish and wildlife species found primarily within units of the National Park System. The bill would work by restricting new federal expenditures and financial assistance that degrade habitat within such units and "within contiguous ecologically related federally managed areas" upon which fish and wildlife species depend.

Senator Chafee's bill is premised on the belief of many ecologists that many of our National Park units require buffer zones to prevent or limit loss of wildlife within parks, and that many park units are contiguous with ecosystems with similar characteristics of great value.

This model legislation would extend the principles of Senator Chafee's bill to restrictions on special interest tax subsidies that promote activities damaging these same key ecosystems on private lands next to National Park System units.

Wetlands of International Importance

A List of Wetlands of International Importance especially as Waterfowl Habitat ("List") is kept under the Convention on Wetlands of International Importance Especially as Waterfowl Habitat, I.L.M. 11:963-976. This treaty entered into force on December 21, 1975. Although the United States has not yet become a party, the Secretary of the Interior recently recommended accession to the treaty. This list consists of areas designated by party nations from suitable wetlands within their territories. Wetlands are to be selected "on account of their international significance in terms of ecology, botany, zoology, limnology, or hydrology." Art. 2, par. 2. Parties are "to promote the conservation and wise use" of listed wetlands. Art. 3, par. 1. Many wetland areas have been placed on the List by the 34 adhering nations. Because the United States is not yet a party, none of these wetlands is located within U.S. territory.

Western Hemisphere Parks, Monuments, and Reserves

National parks, national reserves, nature monuments and strict wilderness reserves are defined by reference to exceptional natural characteristics specified in the Convention on Nature Protection and Wildlife Preservation in the Western Hemisphere, U.N.T.S. 193. Each party to this convention has agreed to create and, where feasible, to afford substantial protection to such parks, monuments, and reserves. The convention entered into force on April 30, 1942. The United States and 16 other nations are parties. The contracting parties have agreed to notify the Organization of American States of any national parks, monuments, and reserves established under the Convention. Apparently no party has yet provided any such notifications, although Barro Colorado Island is designated as a convention nature monument by the Panama Canal Treaty.

Natural Heritage Properties

Natural heritage properties are to be included in a "World Heritage List" kept under the Convention Concerning the Protection of World Cultural and Natural Heritage, T.I.A.S. 8226. This List is established by the World Heritage Committee of party countries. Inclusion of a property requires consent of the country concerned. Natural heritage properties are to have natural features of "outstanding universal value." Art. 2. Each party State has agreed to "do all it can . . . to the utmost of its resources" to ensure the "identification, protection, conservation, presentation and transmission to future generations of the cultural and natural heritage" situated on its territory. Art. 4. In addition, each party has agreed "not to take any deliberate measures which might damage directly or indirectly the cultural or natural heritage" situated on the territory of other party nations. Art. 6, par. 3.

As of November, 1984, 188 cultural and natural heritage properties were included on the World Heritage List. Nine of the twelve U.S. properties are natural heritage properties; all of these are National Parks. U.S. implementing legislation for the Convention requires written concurrence of land owners before the Secretary of the Interior may nominate any non-federal property for inclusion on the List.[5] Extensive listing of such non-federal lands within the United States is therefore unlikely.

Resources of Global Importance

Natural or ecological resources of global importance are to be designated by the President pursuant to subsection 2-3(d) of

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[5] 16 U.S.C. 470a-1(c).

Executive Order 12114 on "Environmental Effects Abroad of Major Federal Actions", signed on January 4, 1979. The purpose of E.O. 12114 is to prescribe the obligations of federal agencies under the National Environmental Policy Act in respect to actions affecting the environment outside of the United States. Designating resources of global importance leads to more thorough review of the environmental impact of federal actions affecting those resources. Removing certain federal tax subsidies for destructive activities in these areas would reinforce the policy of special protection for them. To date, however, no resources of global importance have been designated by the President or recommended to him for designation.

SECTION 2. LISTING OF DESIGNATED NATURAL AREAS

This section would require the Secretary of the Interior to publish a list, with descriptions, in the Federal Register of all natural areas designated under the model legislation. An initial list would be due 180 days after enactment of the law, and publication of revisions to the list would be required within 180 days after any change in designation of areas.

Only these designated natural areas listed in the Federal Register would receive the protection conferred by the amendment to the Code set forth in section 3 of the model legislation. This requirement should ensure taxpayers will be able to identify such areas without ambiguity.

SECTION 3. DISALLOWANCE OF DEDUCTIONS AND CREDITS

Section 3 is the operational heart of the model legislation. The new section 280H would be added to existing Code sections in Part IX that specify items not deductible. Among other items in Part IX are several whose deduction is considered to be against public policy, for example, acquisitions made to evade or avoid income tax (§269) and expenditures in connection with the illegal sale of drugs (§280E).

The new section 280H would apply only to amounts paid or incurred in carrying on activities within designated natural areas. "Designated natural areas" are those areas listed in the Federal Register under section 2 of this Act. The limitations of section 280H(a) would apply only if an activity affected the environment of a designated natural area, and even then would not apply if the Secretary of the Interior has determined that the activity would help to preserve or enhance its natural characteristics. When applicable to an amount paid or incurred in carrying on an activity, section 280H(a) would disallow any credits described below that are otherwise allowable against tax or any of the deductions discussed below that are otherwise allowable.

GENERAL INVESTMENT SUBSIDIES AND TAX SHELTERS

Investment Credit

Section 38 of the Code specifies amounts allowed as a business credit against tax, including investment credit determined under section 46(a). The business credit allowed a taxpayer for any taxable year is limited to $25,000 plus 85 percent of any tax liability exceeding $25,000. §38(c). Business credits may be carried forward up to 15 years or carried back up to 3 years. §39.

The amount of investment credit is the sum of the regular percentage, energy percentage, and rehabilitation percentage of qualified investment. §46(a).

The regular percentage is 10 percent. §46(b)(1). The "general rule" energy credit expired on December 31, 1982, but a 10 percent credit remains available through 1990 for long-term projects that meet Code deadlines for evaluation, authorization, and commitment of resources. An energy credit of 10 to 15 percent also is available until December 31, 1985, for certain property. §46(b)(2). The rehabilitation percentage is 15 percent for 30-year buildings, 20 percent for 40-year buildings, and 25 percent for certified historic structures. §46(b)(4). The regular and energy percentages do not apply to the portion of the basis of any property which is attributable to qualifed rehabilitation expenditures.

The amount of "qualifed investment" is the applicable percentage of section 38 property placed in service by the taxpayer during the taxable year. The applicable percentage is less for used property and for property with a shorter useful life. §46(c).

Section 38 property (with an exception for timber) includes only "recovery property" within the meaning of §168 and any other property with respect to which depreciation or amortization is allowable and having a useful life of 3 years or more. §48(a)(1).

Section 168(c) defines recovery property as "tangible property of a character subject to the allowance for depreciation--(A) used in a trade or business, or (B) held for production of income." Section 38 property is defined specifically as tangible personal property (other than an air conditioning or heating unit) and other tangible property (not including a building and its structural components). Such property must meet one of several conditions; the broadest condition is that such property "is used as an integral part of manufacturing, production, or extraction or furnishing transporation, communications, electrical energy, gas, water, or sewage disposal services . . ." §48(a)(1)(B)(i). Livestock (other than horses) acquired by the taxpayer qualifies as section 38 property. §48(a)(6).

Among other rules on eligibility for credit, amount of credit, and recapture, the Code contains provisions limiting the applicability of investment credit for property used outside the United States, property used by foreign persons or entities, and property completed abroad or predominantly of foreign origin. §48(a)(2), (5), and (7). In general, investment credit is not available for expenditures on these properties. The properties are defined in such a way, however, and with such exceptions, that investment credit is potentially available for amounts spent on many activities with effect outside the United States.

Only property used "predominately" outside the United States, for example, is disqualified under §48(a)(2). Eleven specific categories of property are included irrespective of use. These include documented vessels in U.S. commerce, motor vehicles and containers of a U.S. person used in transporting property to and from the United States, and any property of a U.S. person which is

> used in international or territorial waters within the northern portion of the Western Hemisphere for the purpose of exploring for, developing, removing, or transporting resources from ocean waters or deposits under such waters . . . §48(a)(2)(B)(x).

Property may be used by a foreign person and still qualify for investment credit under §48(a)(5) if, for example, use is under a lease with a term of less than six months (or longer for oil drilling property and containers or aircraft).

Property is not disqualified under §48(a)(7) even though a substantial part was made abroad, unless the property was completed outside of the United States or more than 50 percent of the basis of the property is attributable to value added outside of the United States.

Investment in tiles for drainage of wetlands is cited frequently as an expenditure made less costly by the availability of investment credit. Investment in drainage tiles, however, although a stark example of subsidized environmental harm, cannot be more than a small fraction of the total investment in depreciable, tangible property that harms designated natural areas and that qualifies for investment credit.

The Treasury Department has proposed to repeal entirely the investment tax credit (see Volume II of the Treasury Report, pages 173-176; hereinafter cited in the form "T2:173-76").

Accelerated Cost Recovery System

Section 168 of the Code contains the Accelerated Cost Recovery System (A.C.R.S.). The A.C.R.S. was established by the Economic Recovery Tax Act of 1981, P.L. 97-34, and authorizes accelerated recovery of capital expenditures for most tangible depreciable property, defined as "recovery property" (see above), placed in service after December 31, 1980. The A.C.R.S. was enacted as an alternative to pre-existing rules for depreciation under §167 of the Code, and was intended, as was the investment credit, to provide investment incentives for businesses. The new section 280H's disallowance of deductions under the accelerated schedule of A.C.R.S. set forth in §168(b) would remove this incentive for investment in recovery property that is used in designated natural areas. Recovery property is not generally eligible for deduction of cost under subsection 168(b) if used predominantely outside of the United States, §168(f)(2), or if used by a foreign person or entity, §168(j)(1) and (4). Exceptions exist to these limitations, however, although they are more circumscribed than the exceptions contained in §46(a) to limits on foreign applicability of investment credit.

The Treasury Department has proposed to replace the ACRS system with a Real Cost Recovery System (T2:153-172). The RCRS as proposed apparently would be preferable to depreciation under §167 of the Code as an alternative to ACRS deductions within designated natural areas.

At-Risk Limitations for Real Estate and Equipment Leasing

The Code limits deduction of losses to the amount that an individual or closely held corporation has placed "at-risk". §465(a). No geographic limitation is placed on deduction. A one year carry-forward is authorized for loss disallowed in the taxable year under Section 465. The amount at risk includes money borrowed for use in an activity to the extent that the taxpayer is personally liable or has pledged unrelated property as security. §465(b). Activities covered include generally those engaged in by the taxpayer in carrying on a trade or business or for the production of income. §465(c)(3).

The at-risk limitation does not currently apply to losses from the holding of real property (other than mineral property) or from certain equipment leasing by closely-held corporations. §465(c)(3)(D) and (c)(4). The model legislation would extend the "at-risk" limitation to real estate and equipment leasing activities within designated natural areas. The Treasury proposals would extend the limitation to all activities (T2:334-36).

Expensing Certain Depreciable Business Assets

Section 179 authorizes taxpayers to elect to expense the cost of "section 179" property as a deduction for the taxable year in which the property is placed in service. Section 179 property is defined to mean recovery property which is section 38 property and which is acquired by purchase for use in trade or business. §179(d). Except for the authorization contained in section 179, the cost of such property would be chargeable to capital account.

The aggregate cost of property which may be expensed in any taxable year under section 179 is $5,000 in 1983 through 1987, $7,500 in 1988 and 1989, and $10,000 in 1990 or thereafter. §179(b). No investment credit is allowed under section 38 for any amount deducted under section 179. Deductions under §179 for property used or made outside the United States are subject to the same limitations discussed above for investment credits. The Treasury Department has proposed to retain section 179 but to limit the amount deductable to $5,000 (T2:300-301).

NATURAL RESOURCES

Production Tax Credit

Section 29 provides a tax credit for producing fuel from a nonconvention source. The credit is calculated by multiplying $3.00 times the barrel-of-oil equivalent of qualified fuels §26(a), and reducing that total by an index tied to the price of domestic crude oil. §26(b). Qualifying fuels include oil from shale and tar sands, gas from various organic deposits, synthetic fuels from coal, fuel from qualified processed wood, and steam from solid agricultural byproducts. §26(c). To qualify for the credit, fuels must be sold after December 31, 1979, and before January 1, 2001. §29(f)1). The Treasury Department has proposed to terminate the production tax credit on December 31, 1985 (T2:226).

Percentage Depletion

In the case of mines, oil and gas wells, other natural deposits, and timber, a taxpayer may deduct a "reasonable allowance for depletion and for depreciation of improvements, according to the particular conditions in each case . . . " §611. The basis for depletion is essentially the cost of finding a natural deposit or timber, acquiring ownership, and resource development. A reasonable allowance for deduction in any taxable year is the basis for depletion multiplied by a fraction equal to the number of units of deposit or timber recovered during the taxable year divided by the total number of recoverable units. This method is known as cost depletion and recognizes that taxpayers are entitled to return of captial without income tax. Allowing cost depletion is little different conceptually than allowing depreciation for investment in plant and equipment.

Sections 613 and 613A prescribe an alternative to cost depletion known as percentage depletion. Section 613 applies to listed kinds of mines, wells, and other natural deposits; section 613A prescribes limitations on percentage depletion in the exclusive case of oil and gas wells. §613(d), §613A(a).

Percentage depletion rates are specified in detail by these two sections of the Code. Unlike cost depletion, percentage depletion rates are essentially arbitrary. A deduction is allowed, for example, for 15 percent of gross income from any geothermal deposit in the United States. §613(c).

The general rule for percentage depletion, to the extent that one exists, is 14 percent of gross income from the property. §613(b)(7). The highest rate prescribed is 22 percent. §613(b)(1). Rates may vary depending whether a deposit is in the United States. The percentage depletion for asbestos, for example, is 22 percent of gross income if from deposits in the United States and 10 percent if from foreign deposits. Compare §613(b)(a)(B) and (b)(4).

Although defined by lengthy, complex rules, especially for oil and gas wells, percentage depletion fundamentally allows for more rapid recovery of capital than does cost depletion. In fact, percentage depletion is allowed even after all costs have been recovered.

The model legislation would generally require use of cost depletion allowances for deductions from income from property within designated natural areas. The Treasury Department has proposed to repeal the percentage depletion allowance for all minerals (T2:230).

Intangible Drilling Costs: Oil, Gas, & Geothermal Wells

Section 263(c) of the Code directs the Secretary of the Treasury to issue regulations allowing expensing of intangible drilling and development costs (IDC's) for oil and gas wells and geothermal wells. These rules provide taxpayers with several options. Section 291(b) reduces by 20 percent the amount expensible by corporations under §263(c), and allows amortization of this remainder over 36 months. A five-year deduction schedule is prescribed for IDC's of nonlimited partnerships with respect to wells located in the United States. §58(i)(4).

These allowances are a substantial tax subsidy for the oil and gas industry, and extend to development and exploration. These are unrelated to amount of reserves expected or found. The allowances also favor exploratory drilling over seismic, magnetic, or other exploration technologies. The Treasury Department has proposed to repeal the option to deduct IDC's under §§263(c) and 291(b) for costs paid or incurred on or after January 1, 1986 (T2:233).

Development and Exploration Costs for Hard Minerals

Sections 616 and 617 create additional subsidies to taxpayers engaged in mining. Under cost depletion methods, the cost of exploration and development, other than expenditures on depreciable property, would be added to the basis for depletion. Section 616, however, allows deduction of

> all expenditures paid or incurred during the taxable year for development of a mine or other natural deposit (other than an oil or gas well) if paid or incurred after the existence of ore or minerals in commercially marketable quantities has been discovered. §616(a)

Section 617 allows expensing of amounts paid or incurred during the taxable year

> for the purpose of ascertaining the existence, location, extent, or quality of any deposit of one or other mineral, and paid before the beginning of the development stage of a mine . . . §617(a)(1).

Sections 616 and 617 prescribe no limitations on the geographic location of eligible exploration or development activities. Section 291(b) reduces by 20 percent the amount expensible by corporations and prescribes a five-year period for deduction of this remainder.

Combined, Sections 616 and 617 are a powerful incentive for mining activity. The Treasury Department proposals would repeal the option to expense exploration and development costs after January 1, 1986, and require them to be capitalized (T2:234-35).

Tertiary Injectant Expenses

Expenses for qualified tertiary injectants may be deducted in the year paid or incurred. §193(a). The injectant may not be a recoverable hydrocarbon and the injection must be part of a tertiary recovery method. Because tertiary injectants enhance production over more than one year, usual tax policy would have injection costs capitalized and deductions based upon amount recovered over the life of the project. Section 193 is a production subsidy that complements the allowance for deduction of IDC's. The Treasury Department has proposed to repeal the allowance entirely (T2:236-37).

Royalty Taxation

Taxpayers with interests in coal, domestic iron ore, and timber may pay capital gain tax on royalty income from these interests. §631. Capital gain treatment is anamolous for such income, which would be taxed at ordinary rates if the authorization of §631 were not available. The Treasury Department has proposed to repeal capital gains treatment for income from these sources whenever located (T2:238-39).

FARMING SUBSIDIES

Treatment or Moving of Earth

Section 175 authorizes deduction of expenditures that would otherwise be chargeable to capital account which are paid or incurred "for purpose of soil or water conservation in respect of land used in farming . . ." Up to 25 percent of gross farm income may be deducted in a given tax year and any amounts in excess of 25 percent are deductible in succeeding years. Deductible expenditures include those for--

> the treatment or moving of earth, including (but not limited to) leveling, grading and terracing, contour furrowing, the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds, the eradication of brush, and planting of windbreaks. §175(c)(1).

Section 175 deductions are available for qualified activities only if a farming use has been established before or at the same time as the expenditure is made. Deductions are not allowed under §175 for expenditures made to convert previously uncultivated land to farmland. Taxpayers may deduct expenditures to prevent reversion to an uncultivated state.

however, such as wetland or another more biologically diverse ecosystem.

Section 175 contains no limitation on deductions for qualified activities in foreign countries. As noted previously, the availability of deductions under this section is thought to promote substantially the loss of wetlands in the United States. The Treasury Department has proposed to repeal this authorization entirely (T2:311).

Expenditures by Farmers for Clearing Land

Section 182(a) allows taxpayers engaged in the business of farming to expense amounts paid or incurred in the clearing of land for the purpose of making such land suitable for use in farming. These amounts would otherwise be treated as capital expenditures. The amount deductible for any taxable year may not exceed the lesser of $5,000 or 25 percent of the taxable income from farming during the taxable year. §182(b). No carryforward or carryback is authorized. No amount may be deducted under §182 which is allowable as a deduction without regard to that section. §182(d)(1)(B). The term "clearing of land" is defined to include, but not be limited to, the "eradication of trees, stumps, and brush, the treatment or moving of earth, and the diversions of streams and watercourses." §182(c)(1). "Farming" under section 182 includes "sustenance of livestock" as well as "production of crops, fruits, or other agricultural products." §182(c)(2).

Section 182 contains no limitation for farming in a foreign country. The Treasury Department has proposed to repeal §182 (T2:311).

TAX-EXEMPT BONDS

Industrial Development

Gross income generally does not include interest on federal, state, and local obligations. §103(a). Industrial development bonds (IDB's) are generally excluded from this favored treatment because proceeds from the bonds are used for nongovernmental purposes. Interest on IDB's is excluded from gross income, however, in the case of certain small issues (usually limited to $1,000,000 or less), §103(b)(6), acquisition or development of land as a site for an industrial park, §103(b)(5), and other purposes set forth in §103(b) of the Code.

The Treasury Department has proposed to tax interest on governmental obligations if more than one percent of the proceeds are used by a person other than a state or local government (T2:289-92). That proposal would essentially repeal tax exemption for IDB interest income as it now exists. As discussed by the Treasury report, IDB's have been used increasingly by state and local governments to finance private business, causing "serious erosion in the Federal income tax base . . . " (T2:290).

The model legislation proposed in this report would make all IDB interest income taxable if the issue proceeds are used for an activity within a designated natural area.

FOREIGN AND POSSESSIONS TAX ALLOWANCES

Foreign Tax Credits and Deductions

Besides allowances for state and local taxes, section 164(c) allows deduction of foreign real property taxes, foreign income, war profits, and excess profits taxes, and other foreign taxes which are "paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income)." A foreign tax is a tax "imposed by the authority of a foreign country." §164(b)(4). Foreign income, war profits, and excess profits taxes are not deductible under §164(a) if the taxpayer chooses to take to any extent the benefits of §901 or such taxes are paid or accrued with respect to certain foreign trade income. §275 (a)(4).

Sections 901 to 908 prescribe rules for allowance of credit for payment of foreign tax. In the case of U.S. citizens and domestic corporations, a tax credit is allowed for the amount of any income, war profits, or excess profit taxes paid or accrued during the taxable year to any foreign country. §901(b)(1).

The Treasury proposals would modify the foreign tax credit by limiting the amount of credit to U.S. tax on foreign income calculated by country and by modifying rules for determining the source of income. The proposals would improve the Code, but would fall short of parallel proposals on state and local taxes, whose deduction would be disallowed entirely if not incurred in carrying on an income producing activity.

The reasons given in the Treasury proposals for disallowing deduction of state and local tax apply equally to deduction of foreign taxes and, _a fortiori_, to the foreign tax credit (T2:62-63). Foreign tax deductions and credit provide a federal subsidy for public services provided by foreign governments. Taxpayers in countries with higher tax, up to the rate of the United States, receive more benefits than those in countries with lower tax. The revenues lost to the U.S. Treasury are substantial.

Tropical deforestation from ranching, farming, and forestry is one example of such harm that has been discussed extensively. This report does not propose repeal of the foreign tax credit and deductions entirely; the overall merits of such an action are uncertain. Disallowing deductions and credits for foreign tax paid in carrying on activities within designated natural areas in foreign countries, however, could constitute a major disincentive to activities harmful to such areas and would contribute to reduction of the federal budget deficit.

Possessions Tax Credit

The Code allows a credit equal to the taxable income of a domestic corporation which is attributable to business and qualifed investment income in Puerto Rico and the U.S. possessions other than the Virgin Islands. §936(a). A similar credit is available to certain domestic and Virgin Islands corporations. §394(b). The possessions tax credit is available fully whether or not any tax is paid to the government of the possessions.

The Treasury Department has reviewed this credit and proposed to replace it with a wage credit and then to phase out the wage credit over 10 years (T2:327-29). According to the department's report, Puerto Rico has complemented the §936 credit with its own tax exemptions of up to 90 percent of income from certain enterprises. Reportedly, this combination of credit and incentives "means that qualifying corporations are essentially exempt from tax on their Puerto Rico source income." (T2:327).

Puerto Rico and the possessions of the United States contain unique, insular, tropical ecosystems of great value. Continuing them as tax-motivated investment havens for business may further degrade these delicate areas while discriminating against other jurisdictions that may be better able to absorb the environmental impact with less damage. The model legislation in this report would ensure that tax law does not motivate business and investment decisions destructive to designated natural areas within these ecosystems.

BAD DEBTS AND INSURANCE CLAIMS

Although not addressed in the model legislation, further review is warranted for Code provisions allowing expensing of additions to reserves for bad debts and insurance claims. These provisions represent deductions for roughly estimated future loan losses and insurance claims without discount for the present value of such losses and claims. Because effective tax rate is reduced when reserves are increasing, the deduction discriminates in favor of businesses with escalating bad debts or claims or growing loan and policy portfolios.

The Treasury Department has proposed to repeal authorizations for expensing reserve additions in the case of non-depositary institutions (T2:218-219; Code §166(c)), commercial banks and thrift institutions (T2:246-52; Code §§582, 585, 586, and 593), and property and casualty insurance companies (T2:273-83; Code §§822(c), 824 and 825). These provisions are not addressed in the model legislation because of uncertainty concerning their significance to environmental protection.

STATEMENT OF SUSAN B. KIERNAN, DIRECTOR OF POLICY, SAVE THE BAY, INC., PROVIDENCE, RI

Ms. KIERNAN. Thank you, Mr. Chairman. My name is Susan B. Kiernan, and I am director of policy for Save the Bay, southern New England's largest environmental organization with 10,000 family and corporate members.

Senator CHAFEE. And we welcome you here.

Ms. KIERNAN. Thank you.

Senator CHAFEE. And I am a member.

Ms. KIERNAN. That is right. Save the Bay's mission for over 15 years has been to protect and improve the water quality and ecological integrity of Narragansett Bay. We consider ourselves fortunate to have had many opportunities to work with you, Senator. You have earned the respect of our members, as well as countless others, for your work and proven leadership on environmental issues. I am here on behalf of Save the Bay to support your efforts today and urge the subcommittee to move forward with S. 1839.

We applaud the overall goal of the bill, which is to further reduce the role the Federal Government plays in encouraging environmentally destructive activities. The target of this bill is appropriately the Federal Tax Code, and our reasons for supporting it are threefold. Enacting this bill, in our view, will help protect our coastline from damaging energy operations, will reduce incentives for urban sprawl along our shores, and will make financial as well as environmental sense. In the long run, the bill will aid us in our mission to save Narragansett Bay.

For example, the bill affects certain oil, gas, and coal operations. Our organization was formed 15 years ago to fight the siting of an oil refinery on the bay. We recognized then that such development was incompatible with the unique conditions that make our bay one of the most productive estuaries in the world, a habitat for thousands of marine species that also supports a multimillion-dollar shellfishing and fin-fishing industry. During the 15 years since that proposal was dropped, Save the Bay has been confronted again and again with plans for major energy related developments. On more than one occasion, the sites selected for development were integral parts of the fragile barrier resource system that fringes the southern half of our State and bay. Fortunately, through the vigilant work of thousands of citizens, those sites were saved with some being incorporated into a baywide park system.

In addition, Rhode Island met its energy needs through alternate, more environmentally sound means. When this bill is enacted, our coastline should become less vulnerable to such proposals. Knowing that the tax incentives are very important to industry, we expect under this bill that the parties planning new projects will steer themselves away from sensitive areas of our environment into more suitable locations where the tax breaks will still apply.

The provisions for amending the Tax Code will also reduce certain incentives that are helping fuel the poorly planned urban sprawl across our coastal zone. By curbing tax-sheltered investments in coastal development projects, the bill may ease the pressure to overdevelop our most sensitive environmental areas. The impact on Rhode Island's coastal zone is significant in that the State has 18 existing sites within the coastal area's resource system and another 45 sites being considered for addition to the system in a proposal pending before the Department of the Interior.

Most of them are fragile, undeveloped area beaches which are heavily used as a recreational resource. Many of these barrier beaches protect coastal ponds and salt marshes. They are acknowledged by our scientific community to be irreplaceable nursery grounds for scallops and other marine life. Assuming the nominated sites are added to the system, 16 of 20 Rhode Island coastal communities will have a portion of their coastline designated as part of the CBRS system and therefore be subject to the provisions of S. 1839.

As a result, the bill, which adds an additional layer of protection to these sites, will benefit a majority of the State's population. When the costs of this bill are considered, Save the Bay finds yet another reason to support its enactment. In the long run, we believe the Federal Government will save substantially by discouraging the type of development that in the past has caused millions of dollars of expenditures in beach restoration, flood insurance payments, and disaster aid. Furthermore, given the current situation where environmental management programs at the local, State, and Federal levels all face budget cutbacks, it is irresponsible for the Federal Government to be foregoing or sacrificing revenue through actions that contribute to our environmental management problems. The Federal Government cannot afford it and neither can our fragile coasts. Save the Bay is just one of hundreds of regional environmental organizations working to protect our coastlines. We are confident that those other groups, as members of an environmental constituency, share our views as to the benefits of S. 1839.

On behalf of Save the Bay, I want to thank you for allowing us to participate today; and I respectfully urge that S. 1839 be passed into law.

Senator CHAFEE. Thank you very much. We appreciate that. Of course, we appreciate the wonderful job that Save the Bay is doing. We are delighted. All right.

Ms. Campbell.

[The prepared statement of Ms. Kiernan follows:]

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STATEMENT OF SAVE THE BAY

CONCERNING S.1839

PRESENTED TO THE SENATE FINANCE COMMITTEE

JANUARY 31, 1986

154 Francis Street · Providence, Rhode Island 02903-1175 · 401-272-3540

My name is Susan B. Kiernan and I am Director of Policy for Save The Bay, southern New England's largest environmental organization with 10,000 family and corporate members. Save The Bay's mission for over fifteen years has been to protect and improve the water quality and ecological integrity of Narragansett Bay. In our battle to clean up the Bay, we are fortunate to have had many opportunities to work with Senator John H. Chafee, sponsor of S.1839. The Senator has earned the respect of our members, as well as countless others for his proven leadership on environmental issues. There does not exist a more persistent advocate for Narragansett Bay and having learned of the contents of S. 1839, Save The Bay was not surprised to find that Senator Chafee had introduced this bill. I am here on behalf of Save The Bay to support his efforts and urge the Finance Committee to pass S.1839.

We applaud the overall goal of S.1839 which is to further reduce the role that the federal government plays, either directly or indirectly, in encouraging environmentally destructive activities. The target of this bill is appropiately the federal tax code and Save The Bay's reasons for supporting it are threefold. Enacting S. 1839 in our view will help protect our coastline from damaging energy operations, will reduce incentives for urban sprawl along our shores and will make financial as well as environmental sense. In the long run, S.1839 will aid us in our mission to save Narragansett Bay.

For example, S.1839 affects certain oil, gas and coal operations. Our organization was formed fifteen years ago to fight the disastrous siting of an oil refinery on the Bay. We recognized then that the development of such a facility was imcompatible with the unique conditions that make Narragansett Bay one of the most productive estuaries in the world - a habitat for thousands of marine species that also supports multi-million dollar shellfishing and finfishing industries. During the fifteen years since the first refinery proposal was dropped, Save The Bay has been confronted again and again with plans for major energy-related developments on the Bay. On more than one occasion, the sites selected for development were integral parts of the fragile barrier beach and coastal pond system that fringes the southern half of our state and Bay. Fortunately, through the vigilant work of thousands of citizens those sites were saved, with some being incorporated into a Bay-wide state park system. In addition, Rhode Island met its energy needs through alternate means that were more environmentally sound. However, we have been forced to remain a vigilant watchdog.

When S.1839 is enacted, our coastline will become less vulnerable to such proposals as illustrated by the following example. In meeting recently with the parties backing a coal project, I was candidly told that the tax benefits due to an accelerated depreciation schedule provided the major incentive for their proposal and were crucial to the financial viability of the operation. The project coordinator further stated that if his partnership was unable to take advantage of these tax breaks, then they would not move forward. Given this example of how important certain incentives are to the industry, knowing that they can make or break a project, we expect that the parties planning new projects will steer themselves away from sensitive areas into more suitable locations where the tax breaks will still apply.

We cannot underscore the importance of this bill to our efforts. We have spent countless hours in debates regarding the siting of energy facilities. We anticipate the debate will continue as the upswing in the region's economic growth is accompanied by an increased demand for energy resources. The Governor of Rhode Island has alluded to the fact that eight new generating plants are presently in the planning stages. S.1839 would be an ally in our efforts to insure that such faciltiies and activities are properly planned and sited so as to preserve the long term productivity of Narragansett Bay.

Save The Bay further believes the provisions for amending the tax code will reduce certain incentives that are helping fuel the poorly planned urban sprawl across our coastal zone. By reducing the attractiveness of structuring tax sheltered investments in coastal development projects, S. 1839 may ease the pressure to overdevelop our most sensitive environmental areas.

The impact on Rhode Island's coastal zone is significant in that the state has eighteen existing sites within the Coastal Barrier Resources System (CBRS) with another 45 sites being considered for addition to the system in a proposal pending before the Department of Interior. Most of the areas are fragile undeveloped barrier beaches which are heavily used as a recreational resource. Many of these barrier beaches protect coastal ponds and saltmarshes that are acknowledged by the scientific community to be irreplaceable nursery grounds for scallops and other marine life. Assuming the nominated sites are added to the system, 16 of 20 Rhode Island coastal communities will have a portion of their coastline designated as part of the CBRS and therefore be subject to the provisions of S.1839. As a result, the bill, which adds an additional layer of protection to these sites, will benefit a majority of the state's population.

When the costs of this bill are considered, Save The Bay finds yet another reason to support its enactment. In the long run we believe the federal government will save substantially by discouraging the type of development that in the past has caused million of dollars of expenditures in beach restoration, flood insurance payments and disaster aid.

Furthermore, given the current situation where environmental management programs at the local, state and federal levels all face budget cutbacks, it is irresponsible for the federal government to be foregoing or sacrificing revenue while at the same time contributing to our environmental management problems. The federal government cannot afford it and neither can our fragile coast.

Save The Bay is just one of hundreds of regional environmental organizations working to protect our coastlines. We are confident that those groups, as members of an environmental constituency, share our views as to the benefits of S.1839. On behalf of Save The Bay, I respectfully urge you to pass S.1839 into law.

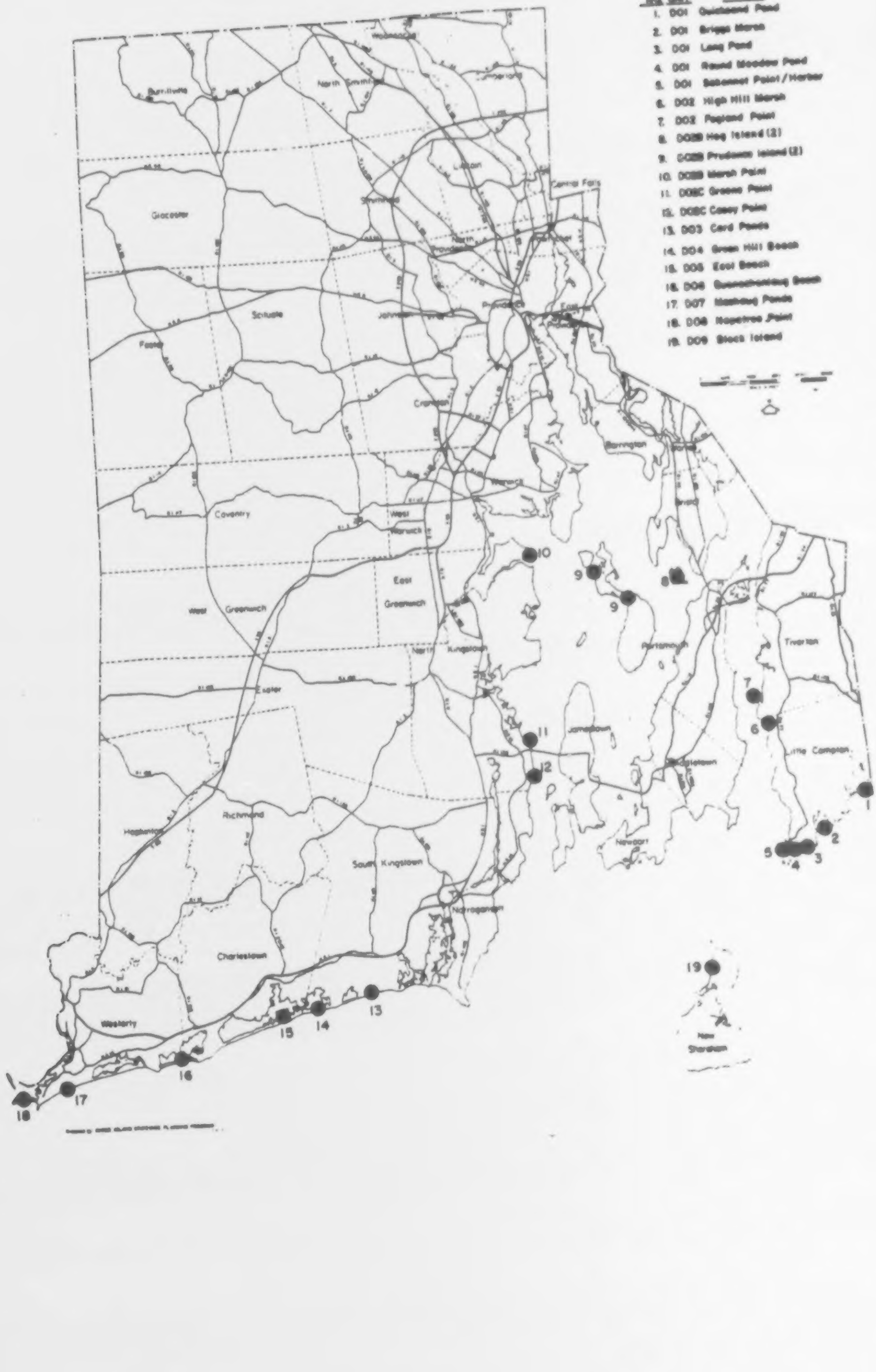
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FIGURE I
EXISTING CBRS UNITS IN R.I.

MAP NO.	CBRS UNIT	NAME
1.	D01	Quicksand Pond
2.	D01	Briggs Marsh
3.	D01	Long Pond
4.	D01	Round Meadow Pond
5.	D01	Sakonnet Point/Harbor
6.	D02	High Hill Marsh
7.	D02	Fogland Point
8.	D02B	Hog Island (2)
9.	D02B	Prudence Island (2)
10.	D02B	Marsh Point
11.	D02C	Greene Point
12.	D02C	Casey Point
13.	D03	Card Ponds
14.	D04	Green Hill Beach
15.	D05	East Beach
16.	D06	Quonochontaug Beach
17.	D07	Maschaug Ponds
18.	D08	Napatree Point
19.	D09	Block Island

STATEMENT OF FAITH CAMPBELL, SENIOR RESEARCH ASSOCIATE, NATURAL RESOURCES DEFENSE COUNCIL, INC., ON BEHALF OF THE NATIONAL WILDLIFE FEDERATION, WASHINGTON, DC, ACCOMPANIED BY SHARON NEWSOME, LEGISLATIVE DIRECTOR, NATIONAL WILDLIFE FEDERATION

Ms. CAMPBELL. Thank you, Senator. My name is Faith Campbell; I am with the Natural Resources Defense Council. With me is Sharon Newsome of the National Wildlife Federation. Our organizations, representing over 4 million Americans, are pleased to support S. 1839. We have a longer statement that we would like submitted for the record.

Senator CHAFEE. That will go in.

Ms. CAMPBELL. Under current Federal tax law, development is heavily favored over conservation by a combination of tax exclusions, credits, deductions, accelerated cost recovery, and other incentives. S. 1839 would eliminate some of these, thus promoting conservation at no cost to the Federal Treasury. We believe this use of the Tax Code is consistent with long-standing practice.

We discuss the provisions of S. 1839 in more detail in our written statement. In the brief time available to us here, we would like to highlight some additional tax breaks that we suggest should be withdrawn and some other areas which would qualify in our minds as environmental zones.

We recommend disallowance of all forms of preconstruction costs, such as capitalization of interest and taxes during construction, deferral of taxes until a structure is occupied by tenants, deduction of sales taxes on building materials, deduction of other business startup costs. We also recommend disallowance of all forms of accelerated cost depreciations for development in environmental zones. We suggest instead allowing only straight-line depreciation. Finally, we urge that capital gains on sales of all assets in environmental zones be considered as ordinary income.

S. 1839 incorporates five categories of environmental zones, all clearly defined by Federal statutes. NRDC and NWF fully support these. We would like to suggest expanding the concept to include some other areas, particularly wetlands, as defined either under the Clean Water Act or the 1985 farm bill; areas designated under State natural area or heritage programs; areas designated under three international treaties named in our testimony; and additional coastal barrier formations in the Great Lakes and Pacific coast areas. Ms. Newsome would like to address those momentarily.

Senator CHAFEE. All right. Ms. Newsome.

Ms. NEWSOME. The federation and NRDC heartily endorse your inclusion of the coastal barrier resources in the environmental zones covered by the bill because it will close present loopholes in the Coastal Barrier Resources Act. Under your authorship, Senator Chafee, Congress established the system in 1982 to minimize the loss of human life, reduce wasteful expenditure of Federal revenues, and reduce the damage to fish and wildlife and other natural resources when coastal barriers are developed.

By withdrawing Federal subsidies, Congress embarked on a new approach to conservation, using the marketplace to achieve conservation goals. An underlying principle of the act is that Federal financial assistance is so pervasive in real estate development that it interferes with and directly affects economic decisions. The Department of the Interior has stated in its report to Congress that in coastal communities tax-induced distortions have severe costs in terms of lost human lives, property, public revenues, and natural resources. Evidence is mounting that without creating a tax differential between economic development and conservation goals, denial of direct Federal subisidies alone cannot establish free market decisionmaking. Thus, differential taxation as proposed in S. 1839 is an essential ingredient. However, the hazard of coastal barrier development is not limited to areas on the Atlantic and gulf coasts. The Great Lakes have had record-high lake levels and erosion problems over the past year; yet building has accelerated. Likewise, the west coast has been subject to severe Pacific storms and tidal waves, which have destroyed inappropriate near-shore development.

The Department of the Interior's report delineates 700,000 acres of new areas in the Great Lakes, the west coast, and Alaska and its territories. We urge you to include those areas in S. 1839.

Thank you very much for the opportunity to comment.

Senator CHAFEE. All right. Thank you very much, Ms. Newsome. Mr. Sellers.

[The prepared statements of Ms. Campbell and Ms. Newsome follow:]

STATEMENT BEFORE
THE SENATE COMMITTEE ON FINANCE

ON

S. 1839

A BILL TO EXCLUDE CERTAIN TAX DEDUCTIONS
AND CREDITS FOR EXPENDITURES
WITHIN ENVIRONMENTAL ZONES

BY

THE NATURAL RESOURCES DEFENSE COUNCIL

AND

THE NATIONAL WILDLIFE FEDERATION

January 31, 1986

INTRODUCTION

The Natural Resources Defense Council (NRDC) and National Wildlife Federation (NWF) are pleased to appear before the Senate Finance Committee to support S. 1839, a bill introduced by Senator John Chafee. NRDC and NWF represent over four million Americans who support conservation of wildlife and wildlands in the United States and abroad.

Under current federal tax law, development is heavily favored over conservation by a combination of tax exclusions, credits, deductions, accelerated cost recovery, and other incentives. Overall tax reform, as now contemplated by the Congress, would not eliminate this bias. Therefore, we recommend amendment of the tax code in order to increase the cost and reduce the internal rate of return of development within the proposed "Environmental Zones" and thereby shift development to other less sensitive locations. These zones include authorized additions to our systems of National Wildlife Refuges, National Parks, and National Forests, areas being studied for Wild and Scenic River designation, the Coastal Barrier Resource System, and critical habitat under the Endangered Species Act. Enactment of S. 1839, particularly if it is strengthened along lines we suggest this morning, will bring U.S. tax policy into accord with national conservation policy. The tax code has historically been used to promote a wide variety of social goals. Enactment of this bill will not be a departure from longstanding practice.

A welcome side benefit of S. 1839 is that it will promote conservation without spending federal money. To the extent that development is foregone, conservation goals will be met and possible future expenditures -- *e.g.*, disaster relief on barrier islands, or acquisition costs for refuges, parks, or forests -- will be reduced. If development proceeds regardless, the treasury will receive larger tax payments than it would have otherwise.

S. 1839 addresses primarily tax incentives which affect the "operation phase" of development. These are indeed the largest incentives and consequently are the most damaging to the environment. Therefore, we applaud the bill's elimination of business and investment tax credit, tax-exempt bond interest, expensing of certain depreciable business assets, and limiting real estate and equipment leasing exceptions to "at risk" limitations.

1. CREDITS. SECTION 3(a)(11). A business credit against tax is allowed under Section 38 of the Internal Revenue Code, limited to $25,000 plus 85 percent of tax liability exceeding $25,000. It can be carried forward as much as 15 years, and carried back 3 years. The business credit includes the investment tax credit determined under Internal Revenue Code Section 46(a): the sum of the regular percentage, energy percentage, and rehabilitation percentage of qualified investments [IRC Sections 46(b)(1),(2), and (4)]. We endorse the disallowance of all investment tax credits applicable to Environmental Zones as in Section 3(a)(11).

2. TAX-EXEMPT BOND INTEREST. SECTION 5(a)(19). Historically, the initial development has been financed privately, often assisted by tax-exempt state and local general obligation bonds and other financial obligations. The interest of state and local tax-exempts is generally not included in gross income [IRC Section 103(a)], and special limitations are placed on tax-exempt industrial development bonds under IRC Section 103(b).

The exemption of interest on state and local debt securities from taxation stems from the doctrine of reciprocal tax exemption. It permits states and local governments to borrow at interest rates lower than other borrowers (e.g., the federal government and private corporations), and has a particular appeal to investors in high marginal income tax brackets. In order to foster tourism and development, numerous states and coastal barrier communities have issued tax-exempt securities for bridges, causeways, roads, and other community infrastructure. Removal of the tax-exempt status of such securities as proposed in Section 5 of S. 1839 will reduce the attractiveness of such securities and act as a disincentive to development.

3. EXPENSING DEPRECIABLE BUSINESS ASSETS. SECTION 2(c)(1). Under Section 179 of the Internal Revenue Code, the cost of certain defined property may be expensed in the year that it is placed in service, rather than being depreciated. Under current law, the total cost of property that may be expensed is $5,000 through 1987, $7,500 in 1988-1989, and $10,000 in 1990 or thereafter. Removal of the authority to expense such property used or in place within Environmental Zones as proposed in S. 1839 will add to the economic disincentives for development.

4. ENERGY-RELATED COSTS AND ALLOWANCES. SECTION 2(b)(2). Under the depletion allowance provisions of the Internal Revenue Code, percentage depletion allowances [IRC Sections 613 and 613A] basically allow more rapid recovery of capital costs than cost depletion [IRC Section 611]. Percentage depletion generally is not allowed in the case of oil and gas production, with certain exceptions for some independent producers and royalty owners. Limiting depletion allowances for oil, gas, or other minerals extracted from Environmental Zones to those determined by the cost depletion method as proposed in S. 1839 will act as a disincentive to such extraction in those areas.

Provisions for deductions for development and exploration costs for hard minerals [IRC Section 193(a)] act as substantial subsidies to the respective industries. To the extent that they are applicable to such activities in Environmental Zones, they should be repealed.

5. DEPRECIATION ALLOWANCES. SECTION 2(b)(1). The NRDC and NWF recommend elimination of accelerated depreciation benefits within Environmental Zones. The Accelerated Cost Recovery System (ACRS) is one of the principal tax shelters available to investors and owners of real property developed since 1980. It makes possible the sheltering of an investor's unrelated income, defers tax liability, and encourages taxpayers to make otherwise uneconomic investments in order to obtain tax benefits. The House bill lengthens the recovery period, but the change may not significantly affect development decisions. S. 1839 also eliminates ACRS but retains overly generous tax benefits for depreciation. Environmental Zones should receive the least tax benefits. Therefore, we suggest an amendment be adopted to allow only straight-line depreciation. This is discussed in greater detail below.

In order to promote conservation, it is essential to influence developers' decision-making in the origination as well as the operation phase. In order to do this, NRDC and NWF suggest further denials of such tax benefits as capitalization of interest and taxes during construction; deferral of taxes until a structure is occupied by tenants; deduction of sales taxes on building materials, ground rental costs, and commitment fees on standby loans not actually funded; deduction of pre-construction costs; and business start-up expenses.

Finally, we urge that capital gains on sales of all assets in Environmental Zones be considered as ordinary income. As currently drafted, S. 1839 reduces tax breaks for sales only of timber, coal, and iron ore from those zones.

6. **ENVIRONMENTAL ZONES.** The bill incorporates five categories of "Environmental Zones" in which the enumerated tax incentives for development would be denied. The NRDC and NWF support these five categories as the bare minimum necessary to achieve the purposes of the bill. All are areas clearly defined by federal statute and/or regulation, including survey bounds.

A. Critical Habitat

Critical habitats are designated by the Secretary of the Interior, sometimes in consultation with the Secretary of Commerce, under the authority of Section 4(a)(3) of the Endangered Species Act. Such areas are determined "on the basis of the best scientific data available and after taking into consideration the economic impact,...". Any area may be excluded from critical habitat if the Secretary "determines that the benefits of such exclusion outweigh the benefits of" inclusion, unless failure to include that area will result in extinction of the species. Since enactment of the Endangered Species Act, critical habitats have been designated for 92 species, totaling about 20,000 square miles. In practice, these areas have been much smaller than the ranges of the particular endangered or threatened species. They are, in every sense of the term, "critical" to the survival of these species Extinction is forever; once gone, these species cannot be resurrected. Since the United States has enacted a policy of ensuring survivial of these species, and in fact spends approximately $30 million annually specifically for this purpose, NRDC and NWF strongly support elimination of tax incentives that promote development of the critical habitats of endangered and threatened species.

B. National Wildlife Refuges, National Parks, and National Forests

NRDC and NWF support the language currently set forth in Section 208H(d)(2) of S. 1839 describing as Environmental Zones lands of the National Wildlife Refuge System (NWRS). Although those lands "authorized by an Act of Congress" include a number of areas important to fish and wildlife resources, it is critical to include in the proposed statutory definition those lands "designated by the Secretary of the Interior" for inclusion in the refuge system. This broader definition is necessary because a majority of lands awaiting protection under the laws governing management of the NWRS were established outside Acts of Congress through the Migratory Bird Conservation Commission, Presidential Executive Order, and withdrawals and transfers between agencies. According to the U.S. Fish and Wildlife Service (FWS), by Fiscal Year 1985 there remained only 10 refuges which had been authorized, and funds appropriated for purchase, but which contained lands still unacquired and unprotected. Many of these refuges simply require the purchase of inholdings to complete the acquisition. The total land area represented by these 10 refuges amounted to approximately 56,000 acres. Because of the large amount of land "designated by the Secretary of the Interior", and the continued pressure on these lands from development and other activities, inclusion of these areas in the Environmental Zone definition is critical. We would reiterate that the S. 1839 definition of Environmental Zone extends protection to all lands of the NWRS for which there are authorizations but not yet appropriations.

The NRDC and NWF also support language to reduce or remove tax credits and deductions for areas authorized for inclusion in the National Park and National Forest Systems.

C. Barrier Islands

S. 1839 is particularly important for closing loopholes in the Coastal Barrier Resources Act (CRBA). The Act, passed in 1982, restricted direct and indirect federal expenditures that promote development within the Coastal Barrier Resource System (CBRS), a network of 186 units of undeveloped barrier islands, spits, and beaches along the Atlantic and Gulf coasts. Congress adopted this legislation in recognition of the special qualities of coastal barriers and the forces affecting them.

Coastal barriers are unstable landforms subject to extreme wind and wave pressures. Left in their natural state the sand and unconsolidated sediments absorb these attacks thereby protecting landward development. In addition, coastal barriers harbor uniquely rich and valuable fish and wildlife populations. The

Department of the Interior has estimated that 85 percent of sport and commercial fish species on these coasts spend a portion of their life cycles in the wetlands and estuaries provided by coastal barriers.

Development in these areas is especially costly. First, the development reduces the ability of the land to cushion the immense power of storms and hurricanes. It destroys the natural resources of the areas. Then, the roads, buildings, and other development must be rebuilt constantly as they are destroyed by erosion and storms.

In a farsighted move, Congress established the CBRS to minimize the loss of human life, reduce wasteful expenditure of federal revenues, and reduce the damage to fish and wildlife and other natural resources when coastal barriers are developed. Thus, Congress embarked on a new approach to conservation, testing whether market concepts, absent federal financial assistance and federal regulatory power, can influence private economic decisions so that conservation goals are achieved. An underlying principle of CBRA is that federal financial assistance is so pervasive in real estate development on the coastal barriers that it interferes with and directly affects economic decisions.

Through its tax benefits and preferences, the principal source of federal financial assistance in the origination and operation phases of coastal barrier development is the Internal Revenue Code. Virtually all economic decisions to develop on coastal barriers are influenced by the IRC. Its tax preferences are weighted so heavily in favor of real estate development and ownership that they must be considered to influence, even distort, virtually all private economic decisionmaking on coastal barriers. As the Department of the Interior's draft Report To Congress aptly points out, "[i]n coastal communities, tax-induced distortions have severe costs in terms of lost human lives, property, public revenues and natural resources."

Evidence is mounting that without creating a tax differential between economic development and conservation goals, without removal or restriction of tax preferences for real estate development, denial of direct federal subsidies alone cannot establish free market decision-making. Under current federal tax law, exclusions, credits, deductions, accelerated cost recovery and other tax incentives heavily favor development over conservation. Tax incentives for conservation are relatively few and do not compete effectively or efficiently with incentives for development under our present system. If market forces are to be the principal federal means of addressing conservation of the CBRS, differential taxation as proposed in S. 1839 is an essential ingredient.

D. Expanding Protection Of Barrier Islands

The hazards of coastal barrier island development are not limited to areas on the Atlantic and Gulf Coast currently included in the CBRS. The Great Lakes have had record-high lake levels and erosion problems in the past year. According to University of Michigan researchers, homeowners along the Great Lakes spend approximately $700 million annually to protect their land from shore erosion, only to lose even more in flood damages. Yet people continue to build on the shore. There has been a dramatic increase in applications for construction permits for new shoreline development projects on Michigan shores -- an increase from 500 permits to 1,300 over the past several years -- according to Christopher Shafer, Director of the Lakes and Streams Protection Agency at the Michigan Department of Natural Resources.

Likewise, the West Coast is subject to severe Pacific storms and tsunami (tidal waves) which destroy inappropriate, nearshore development. In the 1960's a tsunami devastated the bayfront at Crescent City, California. This and other tidal waves caused hundreds of thousands of dollars of property damage to coastal resources on the West Coast. According to Oregon's Coastal Zone Management Association, there is a strong probability that another major storm event will occur within the next 10 to 20 years.

Proceedings from California's Coastal Commission's Conference on Coastal Erosion, California's Battered Coast, shows in case after case how poorly planned coastal development has lead to severe cliff erosion. The federal government cannot afford to finance coastal development that leads to great costs in erosion and storm protection, and eventual property damages.

The Department of Interior's draft Report to Congress has mapped undeveloped coastal barriers in the Great Lakes, the West Coast, Hawaii, Alaska, and the Territories. We strongly urge the Committee to include these areas in the "Environmental Zones" included under S. 1839.

8. ADDITIONAL ENVIRONMENTAL ZONE CATEGORIES. NRDC and NWF suggest that the Committee consider expanding S. 1839 to include other kinds of environmentally sensitive lands. The first of these is wetlands. It is well established that wetlands provide essential habitat to large numbers of fish, wildlife, and plant species, including many species that are commercially valuable, harvested for recreational sport, or are endangered. Wetlands also provide natural water quality control systems by removing excess nutrients, sediment loads, and organic and chemical wastes. Moreover, wetlands recharge groundwater supplies and temporarily store flood waters. We suggest that S. 1839 use either the regulatory wetland definition promulgated under the Clean Water Act, as amended (33 USC 1251 et seq.), or else the statutory wetland definition contained the Food Security Act of 1985 (P.L. 99-198), better known as the Farm Bill. Specifically, we propose the following language:

> "(6) which meets the definition of wetlands as
> set forth in the Clean Water Act, as amended

[33 CFR 323.2(c) and 40 CFR 230.3(t)]"

OR

"(6) which meets the definition of wetlands as set forth in the Food Security Act of 1985 [P.L. 99-198]"

We recognize, however, that simple inclusion of a wetlands definition into S. 1839 will not necessarily ensure that these areas receive full protection from continued drainage and conversion. At the very least, we believe that those federal agencies responsible for wetlands protection -- such as the Fish and Wildlife Service and the Environmental Protection Agency -- must be party to all discussions concerning denial of tax credits for wetlands in Environmental Zones. NWF will be glad to work with the Committee in developing this process and drafting language for inclusion into S. 1839.

A second category is state-designated natural areas. Approximately 30 states now have programs to identify and protect privately owned areas of outstanding importance to the conservation of particular species, plant or animal communities, or geologic features: almost 40 states have Natural Heritage protection programs. We believe that these areas also merit the protection proposed in S. 1839.

Third, NRDC and NWF recognize that in some cases a private landowner may be encouraged to undertake environmentally beneficial investments by a proper tax incentive. We have in mind actions contained in an approved Recovery Plan or Section 10 Habitat Conservation Plan, as provided for in the Endangered Species Act. Other examples might be included. At this time, we do not have specific wording to suggest; it would be extremely difficult to tread the thin line between opening a loophole which would undermine the entire bill and being so strict as to discourage useful action.

Finally, the model legislation developed by the Environmental Defense Fund included areas, both inside and outside the U.S., that are designated under 3 international treaties: the convention on wetlands of international importance especially as waterfowl habitat; the convention on nature protection and wildlife preservation in the western hemisphere; and the convention concerning the protection of the world cultural and natural heritage. NRDC and NWF note that loss of habitat and species extinctions have reached alarming proportions in some regions abroad, particularly the tropics. Therefore, we urge you to consider restoring these areas to S. 1839.

This concludes our statement this morning. NWF will submit additional written comments on S. 1839 as necessary.

APPENDIX I

TAX POLICY ON COASTAL BARRIERS AS A CONSERVATION ALTERNATIVE

By enactment of COBRA the Congress embarked on a new approach to conservation, testing whether market concepts, absent federal regulatory power, and absent federal financial assistance can influence private economic decisions so that conservation goals are achieved. An underlying thesis of COBRA is that federal financial assistance is so pervasive in real estate development on the coastal barriers that it intervenes with and directly affects economic decisions. If federal financial assistance were withdrawn, one could then test whether coastal barrier development was economic under our market system.

The Coastal Barrier Resources Act withdrew most direct federal financial assistance for development on units in the Coastal Barrier Resources System (CBRS). However, direct federal financial assistance (funding for roads, bridges, causeways, water supplies and distribution systems, wastewater treatment facilities, shore protection, and so on) has not generally subsidized the *initial* stages of coastal barrier development. Historically, most initial coastal barrier development has been financed through private sources and tax-exempt state or local debt instruments. As a matter of policy and law, direct federal assistance became available at later stages of development.

COBRA also speaks to withdrawal of "indirect financial assistance" for development on units in the CBRS, which includes financial assistance through the Internal Revenue Code. To date the Internal Revenue Service has made no attempt to amend its regulations to comply with COBRA or otherwise to apply the Code and its regulations to enforce COBRA. *The Internal Revenue Code and its regulations must be amended to comply with COBRA, and the Internal Revenue Service must actively implement its regulations to achieve compliance with the mandate of COBRA.*

The rationale for this position becomes clear on analysis of the Internal Revenue Code and its impacts on coastal barrier development. By its tax benefits and preferences, the principal source of federal financial assistance in the origination and operation phases of coastal barrier development is the Internal Revenue Code. Virtually all economic decisions to develop on coastal barriers are influenced by the Code. Its tax preferences are weighted so heavily in favor of real estate development and ownership that they must be considered to influence, even distort, virtually all private economic decisionmaking on coastal barriers. As the Department of the Interior's Draft Report aptly points out, "[i]n coastal communities, tax-induced distortions have severe costs in terms of lost human lives, property, public revenues and natural resources."

Without creating a tax differential between economic development and conservation goals, without removal or restriction of tax preferences for real estate development, evidence is already mounting that denial of direct federal subsidies alone has little or no influence on initial economic decisions to develop the CBRS. Under current federal tax law, exclusions, credits, deductions, accelerated cost recovery and other tax incentives, heavily favor development over conservation. Tax incentives for conservation are relatively few and do not compete effectively or efficiently with incentives for development under our present system. Even were tax reform to achieve greater tax neutrality than now, conservation would have inherent disadvantages in relation to economic development, for the reforms are designed for greater economic neutrality among different economic activities and institutional types, not to achieve conservation goals.

If market forces are to be the principal federal means of addressing conservation of the Coastal Barrier Resources System, differential taxation is an essential ingredient. We urge that the Department clearly state to the Congress that any residential, commercial, or business development within the CBRS should be denied federal tax preferences.

Our comments on the Department's Draft Report to the Congress are divided into two areas: (1) tax recommendations that should be included in the Department's report to the Congress; and (2) comments on the tax options in the report. Underlying our basic approach to both areas is the need to affect development decisionmaking in the origination phase (from inception through construction, until a building is placed in service), and to affect financial and investment returns in the operation phase.

If the goals of COBRA are to be met, it is imperative that efforts to modify the current tax law or to influence proposals for tax reform be initiated. Chapter VII of the Department's report is an important vehicle in this direction.

I. *Tax Recommendations That Should Be Included in the Department's Report to the Congress.*

A. *Origination phase.*

From a conservation perspective it is important in the origination phase to deny tax benefits from the very outset of a proposed development within the CBRS. The function of the denial is to increase the cost and reduce the internal rate of return on CBRS investments. The aim is to make CBRS investment economically unattractive, inducing investment and development to shift elsewhere.

There are a number of tax issues affecting the origination phase which are not overtly considered in the Department's report, and which should be addressed. Examples include capitalization requirements for interest and taxes during the construction period [IRC sec. 189]; business start-up expenses [IRC sec. 195]; tax amounts that can be deferred until tenants occupy a structure; deduction of sales taxes on building materials, ground rental costs, and commitment fees on standby loans not actually funded [IRC sec. 189]; and deduction of pre-construction costs such as assemblage and soil testing. We urge that the Department address each of these issues in its Report to the Congress.

We strongly urge the Department to recommend to the Congress that the Internal Revenue Code be amended to disallow business and nonbusiness individual deductions, credits, and capitalization of interest expense, state or local taxes (including property, sales, and other taxes), financial fees and related expense, and other costs or expenses associated with pre-construction and construction activities within the CBRS.

B. *Operation Phase*. The greatest tax incentives and tax sheltering opportunities come during the operation phase. We recommend a number of changes to remove or modify current tax credits and deductions which provide strong development incentives. The most important of these include: change of the Accelerated Cost Recovery System [addressed in Part II], removal of business and investment tax credits, disallowance of tax-exempt bond interest and the expensing of certain depreciable business assets, removal of certain exceptions to the "at risk" limitations for real estate and equipment leasing, and disallowance of certain energy related costs and allowances. Each of these is discussed below.

1. *Credits*. A business credit against tax is allowed under Section 38 of the Internal Revenue Code, limited to $25,000 plus 85 per cent of tax liability exceeding $25,000. It can be carried forward as much as 15 years, and carried back 3 years. The business credit includes the investment tax credit determined under IRC sec. 46(a): the sum of the regular percentage, energy percentage, and rehabilitation percentage of qualified investments [IRC secs. 46(b)(1), (2), and (4)]. Property that qualifies for the investment credit is further defined under sections 48 and 168 of the Code.

We urge the Department to recommend disallowance of all investment tax credits applicable to CBRS properties.

2. *Tax-exempt bond interest*. Historically, the initial development of most coastal barriers has been financed privately, often assisted by tax-exempt state and local general obligation bonds and other financial obligations. The interest of state and local tax-exempts is generally not included in gross income [IRC sec. 103(a)], and special limitations are placed on tax-exempt industrial development bonds under IRC sec. 103(b).

The exemption of interest on state and local debt securities from taxation stems from the doctrine of reciprocal tax exemption outlined by the Supreme Court in *McCulloch v. Maryland*, 4 Wheat. 316 (1819). It permits states and local governments to borrow at interest rates lower than other borrowers (e.g., the federal government and private corporations), and has a particular appeal to investors in high marginal income tax brackets. In order to foster tourism and development, numerous states and coastal barrier communities have issued tax-exempt securities for bridges, causeways, roads, and other community infrastructure. Removal of the tax-exempt status of such securities within the CBRS could reduce the attractiveness of such securities and act as a disincentive to coastal barrier development.

We urge the Department to recommend that interest on all state and local debt securities issued to support infrastructure and other development within the Coastal Barrier Resources System be taxable.

3. *Expensing Depreciable Business Assets.* Under Section 179 of the Code, the cost of certain defined property may be expensed in the year that it is placed in service, rather than being depreciated. Under current law, the total cost of property that may be expensed is $5,000 through 1987, $7,500 in 1988 - 1989, and $10,000 in 1990 or thereafter. Removal of the authority to expense such property used or in place within the CBRS would add to the economic disincentives to development within the System.

We urge the Department to recommend that the authority to expense certain depreciable business assets under Section 179 of the Internal Revenue Code be disallowed for property used or in place within the Coastal Barrier Resources System.

4. *"At Risk" Limitations for Real Estate and Equipment Leasing.* Under IRC sec. 465, the amount of loss that an investor may deduct is limited to the amount of capital he or she actually has at risk, including cash and the basis of property contributed to the venture, funds borrowed for the venture for which the taxpayer is personally liable, and the value of other assets securing nonrecourse borrowing. Losses disallowed in a taxable year may be carried forward to the next year.

These limitations do not currently apply to real estate holdings or from limited equipment leasing by closely held corporations. Real estate and equipment leasing investors are thus allowed to offset taxable income with tax losses that are not matched by economic losses, guaranteeing an investor a return that may make an otherwise noneconomic investment feasible.

We urge the Department to recommend that the "at risk" limitations of Section 465 of the Internal Revenue Code be applied to real estate holdings and equipment leasing within the CBRS.

5. *"Hobby-loss" and Vacation Home Expenses.* Under IRC sec. 183, business or investment loss deductions may be unavail-

able if in connection with a business or transaction that the taxpayer engages in for personal satisfaction and without any profit motive. Under "safe harbor" rules, if a profit is realized in two out of five consecutive years, the activity is presumed not to be a hobby.

Where a vacation home is used both for personal purposes and for rental income, expenses must be allocated between personal (nondeductible) and investment (deductible) uses. The provisions of both IRC sec. 183 and sec. 280A must be considered. Section 280A sets use limits on both rental uses and personal uses for determining the deductibility of expenses.

Many coastal barrier properties are acquired for investment and rental purposes as well as for personal uses. Increased restrictions on the deductibility of expenses incurred on such properties within the CBRS would act as a disincentive to the owner/lessor.

We urge the Department to recommend that the Internal Revenue Code be amended to increase the restrictions on deductibility of hobby losses (IRC Sec. 183) and vacation home expenses (Sec. 280A) for properties located within the CBRS.

6. Energy-related costs and allowances. Under the depletion allowance provisions of the Internal Revenue Code, percentage depletion allowances [IRC secs. 613 and 613A] basically allow more rapid recovery of capital costs than cost depletion [IRC sec. 611]. Percentage depletion generally is not allowed in the case of oil and gas production, with certain exceptions for some independent producers and royalty owners. Limiting depletion allowances for oil, gas, or other minerals extracted from areas within the CBRS to those determined by the cost depletion method would act as a disincentive to such extraction in those areas.

We urge the Department to recommend that the Internal Revenue Code be amended to permit use of cost depletion allowances only for any mineral extraction within the CBRS.

Provisions for expensing intangible drilling and development costs [IRC secs. 263(c), 291(b), 58(i)(4)], deductions for development and exploration costs for hard minerals (IRC secs. 616 and 617], and deductions of expenses for qualified tertiary injectants [IRC sec. 193(a)] act as substantial subsidies to the respective industries. To the extent that they are applicable to such activities in the CBRS, they should be repealed.

We urge the Department to recommend repeal of the provisions of Internal Revenue Code Sections 263(c), 291(b), 58(i)(4), 616, 617, and 193(a) insofar as they apply to otherwise qualified activities within the Coastal Barrier Resources System.

II. Comments on Tax Options in Department of the Interior's Report to the Congress.

A. Comments on Tax Options that Reduce the Incentive to Develop Coastal Barriers

1. Restrict the deductibility for casualty loss.

We agree generally with the thrust of this option, but suggest some clarification of the Department's intent. The first sentence of the first paragraph paraphrases Internal Revenue Code (IRC) Sec. 165(c)(3), relating to property not connected with a trade or business or a transaction entered into for profit. Much of the development that can be expected in CBRS units will be hotels, motels, and other trade or business establishments, while other development will be conducted as transactions for profit by corporations, limited partnerships, and others. If casualty losses were to be removed or reduced in CBRS units, it would be appropriate to include trades, businesses, and transactions for profit as well as losses of property not so connected.

We recommend that this paragraph be amended to clarify that the Department recommends that deductions for losses incurred in a trade or business [IRC Sec. 165(c)(1)] and losses from any transaction entered into for profit [IRC Sec. 165(c)(2)] be eliminated for units within the CBRS.

Secondly, the Department has not mentioned IRC Sec. 165(i), Disaster Losses, which permits a taxpayer to take certain disaster losses into account for the taxable year immediately preceding the taxable year in which the disaster occurred. Consistency with the Department's views on casualty losses suggests that the disaster loss provisions also be included.

We urge the Department to recommend that the disaster loss deduction provisions of IRC Sec. 165(i) be eliminated for units within the CBRS.

2. Restrict depreciation allowances.

Modification or removal of the Accelerated Cost Recovery System (ACRS) is especially germane to reduce incentives to develop CBRS units. The ACRS is one of the principal tax shelters available to investors and owners of real property placed in service after 1980. Its provisions greatly enhance the internal rate of return, fuel the growth of tax shelters, and provide powerful incentive to develop. It makes possible the sheltering of an investor's unrelated income, defers tax liability, and encourages taxpayers to make otherwise uneconomic investments in order to obtain tax benefits.

ACRS recovery periods are not based on the economic useful life of assets as under pre-ACRS depreciation rules, and for real estate are significantly shorter than under prior law. ACRS uses accelerated depreciation schedules (for most real property with which one would be concerned in CBRS units, the schedules are based on the 175 percent declining balance method (switching to the straight line method at the most advantageous time). The costs of building components (e.g., air conditioning, electrical, and similar systems) are not separately recoverable over periods shorter than that of the building itself, as was the case under prior law.

In suggesting means to modify the adverse impacts of ACRS, several options are possible. Among them are (1) modifications of ACRS; and (2) reversion to prior law for CBRS properties.

a. Modifications of ACRS. The Department of the Interior's Draft Report espouses modifying ACRS by permitting only a straight-line method of depreciation. Use of the straight-line method alone, without other changes in ACRS, would not provide an adequate disincentive to develop CBRS units. Basis for depreciation allowances, recovery period, and cost recovery of components should also be considered.

We strongly urge the Department to recommend modification of the following elements of ACRS, for properties in CBRS units:

- Apply only the straight-line method of depreciation;
- Continue to allow recovery of the full original cost;
- Permit the taxpayer to elect either a 35- or 45-year recovery period;
- Continue provisions not permitting component cost recovery over periods shorter than the building's recovery period.
- Increase minimum "at risk" investment requirements for CBRS properties from 10% of the adjusted basis of the property to 30%.

If adopted, our recommendations would cause buildings on CBRS units to be depreciated at the annual rate of 2.9% (35-year election) or 2.2% (45-year election), in lieu of the Department of the Interior's apparent 5.0% annual straight-line rate. Component cost recovery periods would be significantly increased over current ACRS law, and over prior law. If adopted the provisions would effectively understate the allowance for CBRS properties' economic depreciation, would create a tax disincentive, and should impair capital formation for real property development on CBRS units. Increasing the minimum "at risk" investment requirements would decrease financing leverage and would significantly reduce the internal rate of return for investors, making CBRS development a less attractive investment opportunity.

b. Reversion to prior law. A second alternative would be to prohibit application of ACRS to properties on CBRS units, and permit depreciation according to prior law, i.e., the ADR system applied to property placed in service before 1981. If so modified, we urge the Department to recommend that the straight-line method of depreciation be used exclusively for CBRS properties. For consistency and ease of administration, building component depreciation would also revert to the provisions of prior law. The effects of this alternative would be similar to those proposed above, although slightly favoring component depreciation, because in almost all instances the component depreciation rates would be less than that of the building.

Of the two options, we favor the first as providing the greatest disincentive to development of the CBRS units. We urge the Department to recommend this option in its Report to the Congress.

3. *Treat capital gains on sales of structures in the CBRS as ordinary income*.

We agree with this option. We also agree with the implication that *losses* from the sale or exchange of such structures would continue to receive capital loss treatment. *We urge the Department to recommend this option in its report to the Congress.*

We suggest that the heading be changed to read: "Treat gains on sales or exchanges of structures in the CBRS as ordinary income". The change would make the heading congruent with both the text and the law.

4. *Disallow deductibility for certain business expenses*.

We agree that disallowing deductibility of business expenses for draining, dredging, or filling could be a disincentive in the development decision process. It is not clear from the Department's statement whether disallowing deductibility also means permitting no other tax recovery of such costs, such as capitalization and amortization of such costs over a period of years. We suggest that the Department recommend that tax recovery not be permitted for these other costs in its Report to the Congress.

A logical extension of this option would be to disallow deductibility of CBRS unit site preparation costs and other costs during the origination phase of development, i.e., from inception through the construction period, until the building is placed in service. Precedent is found in Internal Revenue Code Section 189, requiring amortization of real property construction period interest and taxes.

We urge the Department to recommend an amendment of the Code to disallow deductibility and require amortization of all preconstruction and construction period expense for development on

CBRS units, coupled with denial of an adjustment to basis for any unamortized balance under IRC Sec. 1016 for purposes of determining any loss, in the case of any sale or exchange. [See IRC Sec. 189(c)(2)(B)].

5. Restrict deductibility on interest expenses.

This option needs to be modified to state the law regarding investment interest more accurately, and to clarify the Department's intent. For noncorporate taxpayers, interest on debt to acquire or carry investment property is deductible to the extent of the sum of (a) $10,000, (b) "net investment income", and (c) certain deductions attributable to net-leased property. Amounts disallowed under this limitation for a taxable year are carried forward and treated as investment interest in the succeeding taxable year.

The Department's intent is not clear under this option. The heading "restrict deductibility" implies limited deductibility; the first paragraph implies complete denial of individual, corporate and other interest expense deductions; and the second paragraph focuses on the Department of the Treasury's proposal regarding limited interest expense deductions for individuals. As before, it is not clear whether complete denial, limited deductibility, or an alternative form of recovery such as amortization is offered for consideration. Nor is it clear to whom the option is to apply: corporations; noncorporate individuals; other legal entities, and so on.

We urge the Department to recommend that any deduction of interest by individuals, corporations, partnerships and other legal entities to finance purchase of residential, commercial, or business properties, or other transactions for profit on CBRS units be denied. If adopted, such a measure would be an important factor in neutralizing federal taxes in the development, financing, and operation of real property, trades, businesses, and other transactions for profit on CBRS units.

6. Permit interest expense and tax deductions only for net income derived from CBRS lands.

This option bears an inherent tax incentive to develop and do business on CBRS units. That is, the taxpayer is rewarded with a deduction for deriving net income. It is similar in concept to the Treasury proposal discussed in the previous section, but does not have the advantage proposed by Treasury of a $5,000 cap.

We strongly recommend the Department delete this option from its Report, as it detracts from the force of the Department's immediately preceding option. If this is not deemed possible, we recommend that a fixed dollar ceiling or cap be used.

B. Tax Options that Increase the Incentive to Conserve Coastal Barriers.

7. Allow donation of federal income tax refund.

We agree with this option. but suggest that the Department clarify whether it intends that such donations be treated as charitable contribution deductions or as tax credits [cf.. the political contribution credit]. As either a deduction or tax credit. the option would represent some revenue loss to the United States. but would be more than offset by the benefits of such contributions toward federal purchase of lands within CBRS units.

We believe that the option would not have the administrative and compliance problems experienced by the Internal Revenue Service in administering the political contributions credit: the amounts involved are under the control of the IRS and are immediately verifiable.

We urge the Department to recommend that donation of federal income tax refunds be permitted.

8. Allow tax exempt financing for CBRS protection purposes.

We agree with this option. Perhaps the most straightforward modification to achieve the purposes outlined would be to add a new subsection to IRC Sec. 103(b)(4) exempt activities.

We urge the Department to recommend that the Department's Report urge amendment of IRC Sec. 103(b)(4) to provide for acquisition of real property within designated units of the Coastal Barrier Resources System by any exempt person as defined in IRC Sec. 103(b)(3).

9. Permit deductions for maintenance of compatible uses on CBRS units.

The text of this tax option appears to be incomplete. The heading calls for deductions for maintenance of compatible uses. but the text contains no such proposal.

We urge that the Department recommend to the Congress enactment of a program of revenue loss compensation to states that authorize and implement reduced property tax assessments, deferred taxation, restrictive agreements, or similar property tax measures to encourage conservation uses in the CBRS.

10. Permit deductions for restoration of CBRS features.

This tax option is also wanting for a specific proposal. The text is limited to CBRS units added after a major storm. to restore natural features following a major storm or to repair the effects of "other human activities".

We recommend that the Department expand the concept in its Report to the Congress: (a) to include all CBRS units and (b) to provide a tax deduction for costs incurred for restoration or natural features destroyed, damaged, or removed by whatever cause. Restoration plans should be subject to Department of the Interior approval, both to assure protection of the units, and to aid administration and compliance of the tax provisions.

11. *Permit deductions for appropriate siting of structures and facilities.*

We do not agree with this tax option for several reasons. A tax credit, even more than a deduction, would provide a powerful incentive to develop CBRS units. The option is inconsistent with the thrust of the first six options, which are designed to provide disincentives for such development. Secondly, the analogy to historic building rehabilitation is not apt. The tax credit for historic building rehabilitation has acted as a powerful incentive; an appropriate siting tax credit would also encourage development. No matter how appropriate the siting, we think that the Internal Revenue Code should not be used to encourage development on CBRS units. Other means are available to ensure or reward appropriate siting without providing a financing incentive through the federal tax system.

We recommend that the Department delete this option in its entirety from the Report.

12. *Preferential tax treatment on sales and exchanges.*

We agree with the basic concepts underlying this option. The text succinctly describes a number of tax options, any one or more of which would be appropriate. This is one instance where we feel that it is appropriate that the Department not focus on one tax option alone.

13. *Specifically address CBRS units with regard to donations.*

We agree with the approach taken by the Department in this option. We also agree with the type of legislative amendments suggested to resolve the uncertainty and problems outlined, namely: explicit legislative recognition that units of the System serve a conservation purpose; and authorization for the Department of the Interior to certify that the donation establishes a level of protection adequate to conserve the fish, wildlife, and other natural resources of the System.

We strongly urge the Department to include this recommendation in its Report to the Congress.

13. *Increase incentives to donate property on CBRS units.*

We agree with the Department's general treatment of donated property on CBRS units, and urge the Department to include this section in its Report to the Congress as is, with a few minor changes.

a. Provide carry forward and percentage of adjusted gross income tax credits.

We recommend that the heading be changed to characterize the text more accurately than now. We suggest: "Increase carry-forward and percentage of adjusted gross income deduction provisions for CBRS unit property donations."

b. Provide credits against estate taxes.

We suggest that the term "an offset" be changed to "credit" in the second paragraph, fourth line, to clarify that the Department is proposing credit treatment, not a deduction, for the unused portion of the gift deduction. It may be desirable to provide a rationale for converting the unused portion from a deduction to a credit.

c. Permit donations of CBRS property to be valued at pre-disaster valuations.

Valuation of storm-damaged property at pre-disaster fair market value may not prove to be sufficient incentive to owners to donate their property. In some instances, pre-storm fair market value can be significantly less than the current replacement cost of the property, owing to factors such as accelerated deterioration in the coastal environment, deferred maintenance, inflation, and so on.

We recommend that the Department expand this recommendation to permit valuation at "pre-disaster fair market value or replacement cost, whichever is greater" in its Report to the Congress. The heading should be changed accordingly.

Dynamics of Tax Options.

The administrative concerns addressed under this heading are appropriate and timely. We strongly urge the Department to recommend to the Congress that all of the tax code provisions in the Chapter apply to redevelopment as well as to new development.

State Tax Policies.

This discussion is a useful adjunct to the report, especially the materials addressing the "scope of the project" rule. We suggest that where the term "scope of the project rule" first appears at the top of page VII-18, the rule be succinctly stated. This would be helpful to readers not familiar with the term or the rule.

STATEMENT OF H. WILLIAM SELLERS, VICE CHAIRMAN, LAND TRUST EXCHANGE, CHADDS FORD, PA

Mr. SELLERS. Thank you, Mr. Chairman. I am H. William Sellers, vice chairman of the board of the Land Trust Exchange, which is headquartered in Bar Harbor, ME. I am also director of the Brandywine Conservancy's Environmental Management Center, and our organization is based in Chadds Ford, PA. I was trained in land use planning and have been involved professionally in the conservation of land and fresh water resources for 15 years.

I am speaking in support of Senate bill 1839. The Land Trust Exchange is a publicly supported nonprofit organization with two broad goals: to help local and regional land conservation organizations do the best job possible, and to encourage public attitudes and policies ich are favorable to the activities and purposes of local and regional land conservation. Across the United States, there are more than 500 local and regional groups working to protect special land resources: ecologically fragile land, scenic lands, productive farms, timber and grazing lands, water recharge areas, historic and archeological sites and areas for recreation and education, among other resources.

These local and regional land conservation organizations, often called land trusts, claim a collective membership of more than 350,000 people. The Land Trust Exchange strongly supports the elimination of Federal tax incentives that encourage the development of the environmentally sensitive natural lands, lands which we feel would be better off if they were undeveloped or at least developed in a conservative fashion without the benefit of special incentives. Your bill, Senator Chafee, is an important step in eliminating there environmentally destructive Federal tax incentives.

In my 15 years in land and water conservation I have been convinced that Federal tax policies have frequently worked against the environment. In addition to incentives to improper development, there was also a period when there were no incentives for improvements to our existing industrial base which would have eliminated pollution and other problems. Some of these recent incentives which you are addressing in this bill have helped to redress that imbalance. We feel, however, that it is unwise for the Government to subsidize through tax expenditures, development in areas where other Federal policies say development should not occur. Existing inconsistencies between Federal tax and environmental policies are causing unnecessary economic and environmental costs. Eliminating those inconsistencies and their costs is excellent tax reform.

Treasury had expressed concern that protection of these areas should be left to more direct Federal action. The fact is that Treasury has created disincentives where Congress has provided land conservation incentives. Furthermore, Congress has been working to reduce direct expenditures for critical land conservation. It should be stressed that Senate bill 1839 would not establish a tax penalty system. It addresses only subsidies and does not try to deny deductions for ordinary business expenses.

All areas meeting the definition of environmental zones as set forth in S. 1839 indeed are very high priorities from a conservation standpoint. Land conservation organizations which are members of the Land Trust Exchange go to great effort to help governmental conservation agencies protect land in such areas. It may well be that the Congress should consider expanding the definition of environmental zones and also expand the list of incentives which should be eliminated. I will not recommend any today since we have not conferred as an organization on these, but I do urge that, as work on the bill continues, that careful consideration should be given to whether certain other land types should be added to the definition of environmental zones. Mr. Chairman, in light of our experiences with the Internal Revenue Service, I also strongly urge that some consideration be given to developing a procedure to ensure inputs from resource conservation agencies in the form of a review process. Senate 1839 represents a milestone toward greater fiscal and environmental responsibility on the part of the Federal Government. The Land Trust Exchange appreciates this opportunity to testify in its support. Thank you, Mr. Chairman.

Senator CHAFEE. Thank you very much. Ms. Babcock.

[The prepared statement of Mr. Sellers follows:]

LAND TRUST EXCHANGE

P.O. Box 364, 13 Albert Meadow
Bar Harbor, Maine 04609 207-288-9751

A national network of private land conservation organizations

Testimony of

H. WILLIAM SELLERS, Vice Chairman

LAND TRUST EXCHANGE

Before

The Senate Committee on Finance's

Subcommittee on Taxation and Debt Management

Washington, D.C.

January 31, 1986

In Support of S. 1839

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I am William Sellers, Vice Chairman of the Board of the Land Trust Exchange, which is headquartered in Bar Harbor, Maine. I also am Executive Director of the Brandywine Conservancy, based in Chadds Ford, Pennsylvania. Trained in land use planning, I have been involved professionally in the conservation of land and fresh water resources for fifteen years.

The Land Trust Exchange is a publicly-supported non-profit organization with two broad goals: to help local and regional land conservation organizations do the best job possible; and to encourage public attitudes and policies which are favorable to the activities and purposes of local and regional land conservation. Across the United States there are more than 500 local and regional groups working to protect special land resources -- ecologically fragile lands, scenic lands, productive farm, timber, and grazing lands, water recharge areas, historic and archaeological sites, areas for recreation and education, and a wide variety of other land resources. These local and regional land conservation organizations, often called land trusts, claim a collective membership of more than 350,000 people.

The Land Trust Exchange strongly SUPPORTS THE ELIMINATION OF FEDERAL TAX INCENTIVES THAT ENCOURAGE THE DEVELOPMENT OF ENVIRONMENTALLY SENSITIVE NATURAL LANDS which would better be left undeveloped. S. 1839, introduced by Senator John Chafee, is an important step in eliminating these environmentally destructive federal tax incentives.

In this era of massive budget deficits and urgent need to reduce federal expenditures, it makes no sense whatever -- neither economic sense nor environmental sense -- for our government to subsidize through tax expenditures development in areas where other federal policies say development should not occur. Existing inconsistencies between federal tax and environmental policies are causing unnecessary economic and environmental costs. Eliminating those inconsistencies and their costs is excellent tax reform.

It should be stressed that S. 1839 would not establish a tax penalty system. It addresses only subsidies and does not try to deny deductions for ordinary business expenses.

All areas meeting the definition of "environmental zones" as set forth in S. 1839 indeed are very high priority from a conservation standpoint. Land conservation organizations which are members of the Land Trust Exchange go to great effort to help government conservation agencies protect land in such areas against deleterious development. The Land Trust Exchange's member organizations would greatly welcome the help S. 1839 would provide in the form of reduced incentives for development in the environmental zones.

It may well be that the Congress should consider expanding the definition of environmental zones. I will not recommend today specific other types of land which perhaps should be included, but I do urge that as work on the bill proceeds, careful consideration should be given to whether certain other land types should be added to the definition of environmental zones.

S. 1839 represents a milestone toward greater fiscal and environmental responsibility on the part of the federal government. The Land Trust Exchange appreciates this opportunity to testify in its support. Thank you.

STATEMENT OF HOPE M. BABCOCK, DEPUTY COUNSEL AND DIRECTOR, PUBLIC LANDS AND WATERS PROGRAM, NATIONAL AUDUBON SOCIETY, WASHINGTON, DC

Ms. **Babcock**. Good morning, Mr. Chafee. My name is Hope Babcock. I am deputy counsel of the National Audubon Society. With your permission, I would like to summarize my written testimony and ask that the full text be put in the record.

Senator **Chafee**. It will be.

Ms. **Babcock**. Audubon, one of the Nation's oldest and largest conservation organizations, submits this testimony in support of S. 1839, a bill to eliminate tax subsidies in the form of deductions and credits that harm sensitive ecosystems. Your bill would serve to protect the environment from the exploitation that is encouraged by a Tax Code that gives preferential treatment to development. In this regard, the Tax Code is at odds with other Federal initiatives protective of the environment. This preferential treatment was originally enacted into law to spur development of a harvest of resources, activities at an earlier stage in our history considered to be of dominant public interest.

We now know that uncontrolled exploitation of natural resources ultimately harms the public interest, including the national economy with the result that protection and conservation of these resources has become a primary national concern, a premise explicitly recognized in S. 1839. While S. 1839 would not prohibit these activities from occurring, by removing these incentives it will allow natural market forces to work, which we believe in most instances will favor conservation as a resource. By distinguishing between harmful and beneficial practices, the bill would allow the continuation of subsidized activities that are not detrimental to designated natural areas, while discouraging those that are harmful. At the same time, your bill will help reduce the budget deficit by enhancing revenues.

In my written testimony, I indicate Audubon's support for all the areas included in the term environmental zone, as defined, in section 2(d) of S. 1839, noting in particular the importance of applying these reforms to candidate rivers for designation under the National Wild and Scenic Rivers Act and critical habitat designated by the Secretary of the Interior under the Endangered Species Act. We do, however, urge the committee to consider expanding that term at minimum to include wetland systems.

As you know, these systems are of significant environmental and economic value and are disappearing at an unacceptably high rate, in large part due to development subsidies in the Tax Code. We also ask that the bill be amended to include riparian systems and highly erodible lands, both of which are being adversely affected as a result of the bill's cited provisions in the code.

We note two additional provisions in the Tax Code benefiting farmers and the timber industry respectively, which we would ask the committee to consider for possible deletion. One of these, section 180, by allowing farmers to deduct the cost of fertilizers, encourages the excessive use of fertilizers. Fertilizers are a serious source of surface and ground water pollution. My written testimony goes into greater detail on this front. The other provision, section 194 of the code, contributes to unnecessary lumbering by allowing forest products companies to write off the cost of replanting trees, an activity which is clearly already in the interest of the company and should need no additional incentives.

We ask the committee to look at both of these provisions for possible deletion from the code. We also ask the committee to review the Tax Code from the perspective of encouraging good conservation practices, such as soil conservation measures. While many of these activities arguably are those which should be undertaken without additional Government subsidy, like the replanting of trees just noted above, some of them will have high initial costs and will not immediately be perceived as benefiting the source of the environmental problems. In fact, in many instances, the party who benefits from the application of pollution controls is an unrelated, offsite user of the resource. That is why we favor additional incentives being added to the code, at least in the early stages of implementing some of these programs, such as in the case of the largely voluntary nonpoint source pollution control program in the pending amendments to the Clean Water Act.

The Tax Code is a potent tool for environmental destruction or conservation. We are delighted that the committee recognizes this fact by its consideration of S. 1839. We consider the bill an exciting start toward reforming that code. Thank you very much for your attention.

Senator CHAFEE. Thank you, Ms. Babcock. Ms. Caplan.

[The prepared statement of Ms. Babcock follows:]

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STATEMENT OF HOPE M. BABCOCK

DEPUTY COUNSEL AND DIRECTOR, PUBLIC LANDS AND WATERS PROGRAM
NATIONAL AUDUBON SOCIETY

BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE COMMITTEE ON FINANCE

ON THE SUBJECT OF S. 1839

JANUARY 31, 1986

Mr. Chairman, Senator Chafee, distinguished members of this Committee, my name is Hope Babcock. I am Deputy Counsel of the National Audubon Society and Director of Audubon's Public Lands and Waters Program. Audubon is one of the oldest and largest conservation organizations in the country, with over one-half million members and 500 chapters nationwide and in several foreign countries. Audubon is dedicated to the protection of the environment and to the wise use and conservation of our natural resources. Chief among our concerns are protection of endangered species, wetland and riparian habitat, and the quality of our nation's waters. Therefore, we welcome the opportunity to submit testimony on S. 1839, a bill to amend the Internal Revenue Code to eliminate certain special tax incentives for activities that harm sensitive ecosystems. The introduction of this legislation is particularly timely, in light of budget deficit concerns, as it demonstrates how the twin goals of environmental protection and reduction of the federal deficit can be achieved, in part, through creative fiscal policies.

Past attempts at using the Code for environmental conservation purposes have been largely unsuccessful because of inconsistencies with established tax policy and a lack of specifically identified, and therefore, quantifiable resources. [1/] S. 1839, however, steers clear of these difficulties by suggesting tax-subsidy cuts already targeted for elimination by the President's May 1985 Tax proposal (see, Appendix A) and by designating specific natural areas of ecological significance in which these policies would be applied -- the so-called "environmental zone" (Sec. 2(d)).

As you know, there already are initiatives in federal law providing for the withholding of financial assistance for development in certain sensitive ecosystems, such as prohibiting loans, grants or licenses for environmentally adverse development in federally designated wild and scenic river corridors, and denying new federal expenditures or financial assistance for development on federally designated coastal barrier lands. Yet despite these provisions and federal regulatory policy supporting preservation of important ecosystems, incentives for their development remain embedded in the Tax Code. These incentives were originally enacted into law to spur development and harvest resources, activities at an earlier stage in our history considered to be in the public interest. However, we now know that unmitigated and uncontrolled exploitation of natural resources ultimately harms the public interest, including the nation's economy. Protection and conservation of these resources, as much as development, have become primary national concerns as S. 1839 recognizes. Therefore, we strongly support S. 1839 as it removes these unneccessary incentives and allows natural market forces to work, which we believe in many instances will result in conservation of the resource. However, we would like to see the scope of the bill increased to include other areas of what we consider to be equal environmental importance. We also encourage additional deletions from the Tax Code, some of which have been targeted by the President in his May 1985 Tax Reform proposal (see, Appendix A).

We endorse all of the areas included in this term "environmental zone" as defined in Sec. 2(d) of S.1839. We are especially pleased to see the inclusion of wild and scenic study rivers (16 U.S.C. 1275) in the definition of "environmental zone." Rivers are vital both to the ecosystems in and around them and to our own aesthetic and recreational pleasures. Unfortunately, the very characteristics that qualify our outstanding rivers for wild and scenic study -- primitive or undisturbed surrounding environment, steep sides, deep drops, and rapid water -- also make them suitable for small scale hydroelectric development. The result is that less than 2% of our country's total river mileage remains natural enough to be protected as part of the National Wild and Scenic Rivers System. Of this fractional amount, approximately 9% has been formally designated as part of the federal wild and scenic system. Although designated wild and scenic rivers are protected from unwarranted future development, rivers being studied for potential protection under the law enjoy only a temporary moratorium from exploitation. Even during that period, along their shores and in their beds hard rock mining claims can be staked and patented. Timber land can be acquired on their banks; even preliminary permit applications for hydroelectric facilities can be filed. Incentives in the Tax Code, like deduction of the costs of hard rock mineral exploration and development, investment credit on construction and testing equipment, and depreciation schemes on machinery, encourage these preliminary activities. Once investments are made in conversion of a natural resource, the equities start to tip away from future designation of the subject river and toward its eventual development. Elimination of these incentives will discourage this type of investment in these areas and better preserve the status quo during the study period.

We are also pleased to see the removal of tax incentives as they might apply to designated critical habitat of endangered species (16 U.S.C. 1533). While federal agencies are enjoined under the Endangered Species Act (160SC 1531 et seq.) from authorizing, funding or carrying out any action that adversely modifies the critical habitat of any endangered or threatened species, there is no bar to private activities adversely modifying that habitat. Critical habitat can be lost through private commercial and residential development as well as through private exploitation of natural resources. For example, the endangered grizzly bear inhabits regions of the Rockies and the Pacific Northwest that are sources of timber for the lumber industry. Modification of condor habitat in California from open ranchland to commercial uses threatens the few remaining bird's food source as well as its habitat and will prevent the continuation of the Fish and Wildlife Services' captive release program. A recent final ruling by FWS on three endangered species of beach mice stresses "a substantial decline ... of habitat [occurs] through destruction or adverse impact by development."2/

Tax incentives play a large role in encouraging harmful private development in critical habitat areas. The Code allows companies to accelerate depreciation of their building or harvesting equipment, exempt equipment leasing from "at risk" limitations, and to receive tax benefits from their investments. In some situations, as in the case of candidate wild and scenic rivers, these incentives may make the difference between adverse exploitation and no action. For example, in the Northern Rockies, high road-building and engineering costs coupled with low timber quality might be enough to discourage timber harvesting in critical grizzly habitat. Yet the Code, through investment tax credits and accelerated depreciation on machinery, may provide a company with enough of an economic incentive to pursue habitat destroying activities. These incentives clearly contradict the stated intent of the Endangered Species Act to protect this habitat (16 U.S.C. §1536) and should be removed from the Tax Code.

We are very concerned, however, that S. 1839 does not specifically apply to wetland areas. As Senator Chafee acknowledged in his floor statement accompanying the introduction of this bill, not only are we losing these valuable resources at an unacceptably high rate (nearly one-half million acres a year [3/]), but 80% of this loss is due to agricultural activities [4/] and tax deductions and credits provide "the most significant Federal incentive for farmers to clear and drain wetlands." 131 Cong. Rec. S 15118 (November 7, 1985). While it is true that a particular wetland area may fall within one or more of the other categories of land composing the term "environmental zone" (see, Sec. 2(d)), many such areas may not, particularly so-called isolated wetlands (ie., prairie potholes, pocosin swamps, playa lakes, portions of the Alaskan tundra, etc.).

This rate of loss is not in the public interest. Wetlands provide food and critical habitat for a wide variety of aquatic, avian and terrestrial species, which in turn support million dollar industries. Wetlands aid in flood reduction, recharge and discharge of groundwater, entrapment of pollutants, and stabilization of shorelines, all at no cost to the taxpayer. Wetlands have great recreational value as well. Further, they are functionally interrelated with the other sensitive ecosystems indentified in S. 1839. For example, 20% of all threatened or endangered plants and animals depend on wetlands for survival.[5/]

Both Congress and the Executive Branch have recognized the value of wetlands and the need to protect them. Federal initiatives to protect these systems do exist (eg., Executive Order 11990 "Protection of Wetlands (1977) and §404 of the Clean Water Act (33 U.S.C. 1344)). Just last session, Congress denied commodity subsidies for farmers who convert wetland areas into farm land (Pub. L. 99-198). Other programs (e.g., the Migratory Bird Conservation Fund of 1934, the Wetlands Loan Act of 1961, the Land and Water Conservation Fund Act of 1965, the Water Bank Act of 1970) provide funding for wetland acquisition and/or conversion. But the yearly destruction of wetlands continues, due in part to deficiencies in §404, but also due to financial incentives for their destruction.[6/]

Through the Internal Revenue Code's incentives for agricultural and oil and gas development of wetland systems, the government actually deviates from its stated intent to protect wetlands. Under the Code, farmers, miners, energy and timber companies can frequently take advantage of one or more of the following tax subsidies:

- investment tax credits for the installation cost of drainage tiles and of other tangible property (§38);
- accelerated cost recovery systems to recapture capital expenditures made for most tangible depreciable property placed in service after 1980 (§168);
- deductions up to 25% of the money expended for soil or water conservation in a given tax year which would otherwise be chargeable to capital account (§175) (this includes money expended on preventing reversion of cultivated land to an uncultivated state);
- expensing of certain depreciable business assests (ie., §38 property) which would otherwise be chargeable to capital account (§179);
- expensing amounts, which would otherwise be treated as capital expenditures, paid for land clearing activities (e.g., "eradication of trees, stumps, and brush, the treatment or moving of earth, and the diversion of streams and watercourses" (§182(c)(1)) for the purpose of making that land suitable for farming (§182);
- deduction of a "reasonable allowance" (anywhere from 14 to 22% of gross income from the property, depending on the type and location of the property) for depletion and for depreciation of improvements made for mines, oil and gas wells, other natural deposits, and timber (§§613 and 613A) (this method allows for more rapid recovery of capital than does cost depletion);

- employment of more favorable depletion methodologies for development and exploration expenditures in mining than would otherwise be allowed under cost depletion methods (§§616 and 617);
- deductions for intangible drilling and development costs (§263) and employment of tertiary injectants (§193);
- tax credits for sales of nonconventional fuels (§29(d);
- use of "at risk" limitations (§465(c)); and
- treatment as a capital gain or loss income for the sale or exchange of timber, coal or iron ore (§631).

The Code also grants tax exempt status for industrial development bonds (§103). Each of these tax "breaks" encourages conversion of wetlands to non-wetland uses.

While S. 1839 recognizes the adverse effect of these provisions on other types of fragile and important ecosytems and proposes their elimination from the Code; it does not do so for wetland systems. We urge this Committee to add wetlands, defined as in the 1985 Farm Bill, to the areas included in the "environmental zone" (Sec. 2(d)). The necessity of protecting our remaining wetlands calls for no less.

We also urge this Committee to consider adding to the systems included in the "environmental zone" two other important natural areas: riparian habitat and highly erodible land.

General riparian habitat, unlike wetlands, wild and scenic rivers, or critical habitat (unless it falls under one of those categories of habitat), is as yet without any systemic protection. These strips of land bordering on streams and rivers are critical natural systems.[7/] It is the very relatedness of riparian habitat with other ecosystems, such as wetlands, coastal barrier land, national parks and refuges, and wild and scenic rivers, that makes them so important and threatened. Because of their "high degree of connectedness and their great perimeter-to-area ratio as compared to upland ecosystems," riparian habitats "interact extensively with adjacent ecosystems."[8/] The Office of Technology Assessment has declared riparian ecosystems to be "unique, owing to their high species diversity, high species densities, and high productivity relative to adjacent areas."[9/] Riparian vegetation also aids in preventing agricultural runoff and provides excellent wildlife habitat, especially in the West where water and water dependent vegetation are very scarce.

Yet, because of their relation to other ecosystems, riparian habitat is subject to the very same development pressures and resulting harms -- drainage for farming, development of stream banks for commercial, industrial, residential, and recreation purposes, and resource exploitation -- as are the ecosystems covered by S.1839. Deductions for clearing and draining, treatment or moving of earth, development and exploration costs for hard rock minerals as well as investment tax credits and accelerated depreciation on equipment all contribute as incentives for detrimental activities in the riparian zone.

Riparian systems are in need of at least the same protection offered to related ecosystems. The same tax subsidies that harm already designated areas also threaten streamside zones. We ask this Committee to consider adding general riparian habitat to the definition of "environmental zone" in Sec. 2(d) of S. 1839.

Our final recommendation for inclusion in the definition of "environmental zone" is admittedly of a different order than wetlands or riparian habitat. Highly erodible land is more than an ecologically sensitive area; it also represents a source of environmental harm, contributing disproportionately to soil loss and agrochemical water pollution. Soil erosion, in the form of nonpoint source pollution, has been identified by state water pollution control officials "as the primary reason that many streams still are not satisfying water quality standards."[10/] Soil erosion causes adverse instream biological, recreational, navigational, and water storage impacts. The off-farm costs of soil erosion from farmland have been calculated to cost this nation an estimated $3.4 to $4 billion a year.[11/] Soil erosion, itself a pollutant, also exacerbates the problem of agricultural runoff containing pesticides and nutrients. Our nation's soil is a vital resource that deserves the same protective treatment that would be afforded other areas, particularly from a Tax Code that fosters poor soil use. As a factor negatively affecting wildife, agriculture, water and air quality, and recreation, eroding soil demands immediate attention.

As in the case of wetlands, Congress has already recognized this need in the 1985 Farm Bill by authorizing the Secretary of Agriculture to withhold federal commodity subsidies from farmers who cultivate highly erodible cropland ("sodbusting"). In addition, both the House and Senate have passed an amendment to the Clean Water Act that would encourage states to develop programs to abate nonpoint source pollution and would eliminate subsidies that encourage activities resulting in soil erosion.

Yet the Tax Code continues to encourage soil erosion by providing tax incentives for farming activities regardless of land classification. Thus speculators may expense the costs of clearing highly erodible land and depreciate land-clearing equipment on an accelerated schedule.[12/] Farmers also receive special tax breaks such as investment tax credits for livestock and aquifer depletion allowances. A Montana study found that the capital gains treatment and investment tax credit amounted to $33.47 and $10.86 per acre subsidies, respectively, for top bracket speculators, who "farming the Tax Code," purchased grassland that they then plowed up and resold as cropland only five years later.[13/]

Adding highly erodible land, as defined in the 1985 Farm Bill, to the definition of "environmental zone" and thus removing incentives to exploit fragile lands would discourage farmers from bringing these fragile lands into crop production and from creating a host of subsequent environmental problems. Such an action would be consistent with other actions toward that end taken by this Congress in the 1985 Farm Bill, the pending amendments to the Clean Water Act, and legislation that has already passed the House (H.R. 3838, the Tax Reform Act of 1986).

There are at least two other provisions in the Tax Code which unnecessarily encourage destruction of the national environment and might be worth including in S.1839 for deletion. These are §180, which allows farmers to deduct expenditures for fertilizers, and §194, which allows timber products companies to deduct the cost of reforesting timbered areas.

Excessive use of fertilizers is leading to serious groundwater contamination and potentially serious health effects in the agricultural areas of our country. Nitrogen-N levels in Nebraska's groundwater are twice the national drinking water standards for that pollutant. Nitrate levels in Iowa rose to such high levels in May of 1983 that the state debated whether or not these excessively high levels posed a health threat to babies. A 1985 study by the Environment and Energy Study Institute Staff[14/] revealed that between 25 and 30 pounds of nitrogen are lost to groundwater for each acre of fertilized soil. Excessive levels of nitrogen reduce the oxygen carrying capacity of blood which can, in extreme cases, lead to asphyxiation and according to a recent Australian study, a three to four-fold increase in the risk of birth defects.[15/] Phosphates cause overenrichment of estuaries and lakes, causing them eutrophication.

These problems are implicitly recognized in the pending reauthorized Clean Water Act in an amendment to 301(g), making it more difficult for fertilizer manufacturers to get variances from the law's effluent limitations, and in proposed Section 319, requiring states that participate in the nonpoint source program to evaluate the effect on groundwater of the application of best management practices which could cause ponding on farm fields and subsequent leaching into groundwater of both pesticides and nutrients.

Similarly, over-timbering of land causes serious environmental problems from loss of important habitat to water pollution. Section 194 subsidizes the cost to timber companies of replacing small trees in timbered areas. This cost should be a normal cost of engaging in this activity on private or public lands for which no subsidy is received. Reforestation is simply basic resource conservation which should need no artificial stimulant. Removing this stimulant might also slow down the rate at which we are deforesting our public land and conform that activity more closely to decreasing market demands.

In each case, removal of incentives that encourage excessive use of fertilizers and over-timbering would leave the financial risk of engaging in these activities as it is without artificially eliminating that risk.

We also ask this Committee to consider how the Tax Code might be reformed to encourage conservation activities as opposed to disallowing incentives for activities harming specific natural areas. Tax incentives and credits for activities that will help preserve or enhance the natural characteristics of an area should be maintained. Currently, §175 authorizes deduction of expenditures that would otherwise be chargeable to a capital account which are paid or incurred "for purposes of soil or water conservation in respect to land used in farming." S. 1839 appropriately seeks to disallow this deduction for activities in the "environmental zone." Sec. 2(c). However, expenditures under §175 for conservation activities which reduce erosion or conversion of important habitat to other uses (e.g., credits for establishing hedgerows, shelter belts and grass waterways, installing terraces etc.) at no environmental cost to wetlands, riparian zones, candidate river systems, highly erodible lands, or endangered species habitat should be allowed to encourage those activities. Tax breaks for investments in habitat improvement or maintenance of riparian zones, and depreciation of equipment used to prevent erosion, might also be examined by this Committee. Alterations in the valuation and tax status of ecologically valuable land to provide greater encouragement for owners to donate these areas to conservation groups or government agencies under §170 might be worthy of study. One specific area for further study is current IRS under-valuations for donations of scenic easements.

With a regimen of disincentives for activities that harm the environment and incentives to protect and conserve it, we believe that the Internal Revenue Code can be transformed into a potent tool for environmental protection and natural resource conservation. The proposed bill is a welcome first step toward that goal.

We thank the Committee for its attention to our ideas and would be pleased to try and answer any questions that you may have.

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CITATIONS

1/ United States Department of the Interior, Coastal Barrier Resources System Draft to Congress, April 1985, VII-5.

2/ United States Fish and Wildlife Service, Endangered and Threatened Wildlife and Plants; Determination of Endangered Status and Critical Habitat for Three Beach Mice, 50 C.F.R. Part 17.

3/ Office of Biological Services, Status and Trends of Wetlands and Deepwater Habitats in the Coterminous United States, 1950s to 1970s.

4/ Office of Technology Assessment, Wetlands: Their Use and Regulation, March 1984, p. 87.

5/ O.T.A., Ibid., p. 6.

6/ Harmon and McConnell, "The Politics of Wetland Conservation: A Wildlife View," Journal of Soil and Water Conservation, March-April 1983, p. 95.

7/ Riparian habitat may be distinguished from other ecological areas as "zones associated with surface water that reveal, through their vegetation, the effects of that water. A riparian zone, in short, is the interface between an aquatic environment and a drier terrestrial zone that filters or traps pollutants moving from the land to the water." Impacts of Emerging Agricultural Trends in Fish and Wildlife Habitat, Committee on Impacts of Emerging Agricultural Trends on Fish and Wildlife Habitat, 1982, p. 207.

8/ Lowrence, Leonard and Sheridan, "Managing Riparian Ecosystems to Control Nonpoint-Source Pollution," Journal of Soil and Water Conservation, Jan-Feb. 1985, p. 87.

9/ O.T.A., op. cit., p. 30.

10/ Clark, Havercamp and Chapman, Eroding Soils -- The Off Farm Impact, Conservation Foundation, p. xiii.

11/ Ibid.

12/ Audubon agrees with the Treasury II recommendation that all expense treatment of land clearing costs be eliminated for all lands. With expense treatment, farmers can deduct development costs the year that they are incurred, in the same way as they deduct costs for inputs whose benefits are entirely realized in that year. Thus, it is a subsidy to speculators who introduce marginal land into production. Encouraging the introduction of new cropland is a waste: new land has few benefits in a country plagued by persistent farm surpluses but many costs to people and wildlife downstream. Capitalizing land clearing costs could end senseless exploitation of marginal lands.

13/ Watts, Bender and Johnson, Economic Incentives for Converting Rangeland to Cropland, Bulletin 1302 Cooperative Extension Service, Montana State University, Bozeman, November 1983, p. 11.

14/ Environment and Energy Study Institute Staff Report, "Groundwater Protection: Emerging Issues and Policy Challenges," 1985.

15/ Dorsch, Margaret M., et al., "Congenital Malformations and Maternal Drinking Water Supply in Rural South Australia: A Case-Control Study," 119 American Journal of Epidemiology, No. 4, p. 473-85 (April 1984).

APPENDIX A

Since S. 1839 was prepared, President Reagan has presented to Congress proposals for sweeping changes in the Internal Revenue Code. The President's proposals, Treasury II, would alter or eliminate several of the subsidies which S. 1839 would deny to activities that harm designated natural areas. The effect of Treasury II on the tax subsidies which fall under the bill would be as follows (page numbers refer to The President's Tax Proposals to Congress for Fairness, Growth and Simplicity):

1) Production credit -- pp. 224 & 226
Repealed by Treasury II.

2) Investment tax credit -- pp.160 - 163
Repealed by Treasury II.

3) Exemption for interest from IDB's -- pp. 282 - 287
Treasury II would greatly reduce the current exemption, by making IDB's taxable if more than 1% of income used for private purposes.

4) Foreign tax deduction
Current code maintained by Treasury II.

5) Accelerated cost recovery deductions (ACRS) -- pp. 132-159
Treasury II would replace ACRS by the "Capital Cost Recovery System" (CCRS) which sets new depreciation classes, recovery periods and schedules, and adjusts bases for inflation. Like ACRS, CCRS would allow cost recovery faster than economic depreciation for most capital (according to the tables on pp. 158 - 159 of the president's proposal) so it too would serve as a subsidy for developing fragile areas. Treasury II would rely on a third depreciation scheme, the "Real Cost Recovery System," to measure the amount of tax preference which CCRS affords, for purposes of calculating the alternative minumum tax (p. 336). The same principle could be used to end tax preference for activities which degrade a designated natural area.

6) Soil and water conservation deductions -- pp. 183, 187 & 191
Repealed by Treasury II.

7) Expensing depreciable business assets -- pp. 179 - 181
Current system limits expense treatment to $5,000, increasing the limit to $7,500 for 1988 and 1989 and to $10,000 thereafter. Treasury II would keeps the limit at $5,000.

8) Deductions for clearing land -- pp. 183, 187 & 191
Treasury II would repeal.

9) Tertiary injectant
Current code maintained by Treasury II.

10) Deduction of intangible drilling costs (IDCs) -- pp. 231 - 233
IDCs could still be deducted as income under Treasury II. The amount of the IDC deduction that is considered as a tax preference for the corporate minumum tax would be modified but this would scarcely affect the magnitude of the subsidy.

11) Exemptions from at-risk limitations -- pp. 325 - 327
Treasury II would make real estate subject to the at-risk limitation but equipment leasing would remain exempt.

12) Percentage depletion allowances -- pp. 228 - 230
Treasury II would repeal percentage depletion allowances for minerals (5 year phase out). Howver, it would maintain the current subsidy for oil and gas stripper wells run by independent producers.

13) Deduction of hard minerals exploration and development
Current code would be maintained by Treasury II.

14) Capital gains treatment for royalty income -- pp. 234 - 235
Treasury II would phase this treatment out by 1989.

15) Foreign tax credit -- pp. 385 - 389
Treasury II would impose limits to make the amount of the credit specific to the tax rate of the country in which income is earned.

16) Possessions tax credit -- pp. 307 -313
Treasury II would replace the credit with a permanent wage credit.

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STATEMENT OF RUTH CAPLAN, EXECUTIVE DIRECTOR, ENVIRONMENTAL ACTION, WASHINGTON, DC

Ms. CAPLAN. Thank you, Mr. Chairman. My name is Ruth Caplan. I am executive director of Environmental Action. I thank you for this opportunity to testify today. I am also testifying on behalf of the Sierra Club Environmental Policy Institute and Friends of the Earth.

Over the last year, there has been increasing recognition by environmental communities of the critical role which the Tax Code plays in shaping the way in which our natural resources are used. The current tax preferences, deductions, and exemptions distort the allocation of economic and natural resources. They subsidize and encourage accelerated and more intensive exploitation of our farmland, our forests, our minerals, and our ecologically sensitive natural areas.

We are testifying today in support of S. 1839 which is an important step toward the goal of removing environmentally harmful provisions in our tax laws. We hope that this will foster further discussion regarding the environmental impacts of the present Tax Code. Some specific concerns I would like to raise this morning include the fact that, while our national parks and forests and the environmental zones in this bill clearly need protection, there are many other environmentally sensitive areas which have not been given special status and need protection. One of our particular concerns here is the building of second homes, and we would recommend that the interest deduction for second homes be deleted from the Tax Code as a part of tax reform this year.

We are also concerned in the area of timber where the lower capital gains rate which was first established in 1944; at that time the forest products industry claimed that there would be a number of major conservation benefits. These benefits have not been realized. This has been recognized by the Congressional Research Service, the Government Accounting Office, and most recently, in Treasury I by the Treasury Department itself. We think that the step in S. 1839 of eliminating capital gains in the areas under consideration for protection is an important step; but we would go further and recommend that the capital gains provision is not meeting its original goal and should be eliminated all together.

At the very least, we would have it eliminated from all national forest flags. I would raise here a concern by the wilderness society, which has studied the comparative economics of private holdings versus national forests, and has concluded that there are major subsidies for the use of timber in our national forests because of the management by the Federal Government, which amounts to about $2 billion a year, and that removal of the capital gains treatment in the national forests would help to rectify this imbalance.

Agriculture is another area, Mr. Chairman, where we are dealing with a very environmentally sensitive area. We would recommend this whole area be examined as a part of tax reform. I have attached to our testimony a statement by Jack Doyle of the Environmental Policy Institute, which sets forth a number of these problems. I won't go into them right now. Finally, in the area of energy, while S. 1839 addresses some concerns with oil and gas drilling, we would point out that currently in our tax bill there is a tremendous inequity with $27 billion in tax expenditures for energy. Of this about $16 billion is going to nonrenewable; only about $1 billion, even when you have the tax credits for conservation and solar, going for renewables and solar. We think that this inequity is environmentally damaging. You know well the many concerns that we have in relation to nuclear and fossil power; and we would point out further that in addition to the traditional investment incentives that have encouraged these forms, that the pollution control bonds are also encouraging or also being used for major subsidies for nuclear powerplants. We think this should be also examined.

Senator CHAFEE. I am afraid we will have to ask you to conclude, Ms. Caplan. Do you have a summary?

Ms. CAPLAN. Yes; I would just conclude by saying we would urge the subcommittee in examining tax reform this year to consider the broad range of environmental concerns in relation to the Tax Code. Thank you very much, Senator.

Senator CHAFEE. Thank you very much, Ms. Caplan.

[The prepared statement of Ms. Caplan follows:]

ENVIRONMENTAL IMPACTS OF THE INTERNAL REVENUE CODE

Testimony Presented by Ruth Caplan
Executive Director, Environmental Action

Before the Senate Finance Committee
Subcommittee on Taxation and Debt Management

January 31, 1986

On Behalf of

Environmental Action
Environmental Policy Institute
Friends of the Earth
Sierra Club

Introduction

Mr. Chairman, thank you for this opportunity to testify on S 1839 and to share our concerns regarding the environmental impacts of the tax code.

Over the last year, there has been increasing recognition by the environmental community of the critical role which the tax code plays in shaping the way in which our natural resources are used. The existing tax code is encrusted with barnacles in the form of tax preferences, deductions and exemptions which distort the allocation of economic and natural resources. These provisions subsidize and encourage accelerated and more intensive exploitation of our natural resources--our farmland, our forests, our minerals and our ecologically sensitive natural areas.

We support S 1839, introduced by Senator Chafee, which is the subject of today's hearing. This bill, which would exempt certain environmentally sensitive areas from tax incentives that encourage developmental activities, is an important step toward the goal of removing environmentally harmful provisions in our tax laws. We commend Senator Chafee for taking this step and hope this will foster further discussion regarding the environmental impacts of the present tax code.

Major Environmental Impacts of the Tax Code

1. Natural Areas. The development of environmentally sensitive areas is encouraged by the investment incentives provided by the Internal Revenue Code, including accelerated depreciation, the investment tax credit (ITC), and interest deductions for second homes. S 1839 addresses the use of accelerated depreciation and the ITC within environmental zones, as defined in the bill.

The mortgage interest deduction for second home development should also be included in the bill, since it provides a significant incentive to development in environmentally senstive areas. Anyone driving along the Outer Banks of North Carolina where there is not National Seashore designation or ascending to the mountain resorts surrounding Aspen, Colorado, can easily observe the impact of this incentive.

While the areas included in the bill clearly need protection, there are many other environmentally sensitive areas, such as much of the Outer Banks and Aspen, which have not been given special status such as a national park, wildlife refuge or forest, or included in the Coastal Barrier Resources System. Removal of the interest deduction for second homes would help protect these areas from rapid exploitation.

2. Timber. When Congress first agreed to tax timber at the lower capital gains rate back in 1944, the forest products industry claimed that there would be major conservation benefits, including: improved forest protection; improved forest reproduction and cutting; and increased U.S. forest resources. Over the last four decades, it has become clear that these benefits have not been realized.

As pointed out by the Environment and Economy Project, the capital gains treatment is extended to the landowner who sells timber to clear land for agricultural, second home or any other non-forestry use. Not surprisingly, a million acres of private forest was lost to non-forest uses from 1952 through

1976. Further, the capital gains tax benefit is available to firms that buy private or public timber and do not themselves incur any forest management or reforestation costs. Nor are there any standards by which to measure whether landowners are adequately managing their land. As a result, the capital gains tax benefit has been shown to be three times greater than the estimated reforestation costs. The Congressional Research Service, Government Accounting Office and, most recently, the Treasury Department, agree that the capital gains treatment of timber does not promote conservation goals.

S 1839 would eliminate capital gains for timber in environmental zones that would include national forests. While this would have a beneficial impact on our national forests by removing some of the economic incentive for lumbering, it could place undue pressure on privately held lands and encourage lumbering in environmentally sensitive areas outside the designated environmental zones. The overall impact of selective removal of the capital gains provision for timber should be studied carefully.

From an environmental perspective, we support complete elimination of the capital gains treatment for timber.

3. Agriculture. The tax code has had a pervasive influence on agricultural practices, often encouraging environmentally damaging practices. Investment incentives such as the ITC and accelerated depreciation have encouraged capital-intensive, absentee-owned farming operations, which are heavily dependent fertilizer, pesticides and herbicides.

These tax incentives, combined with capital gains treatment of certain farm income, have encouraged agricultural investments motivated by tax shelter benefits. Such economic incentives do not encourage an ethic of stewardship of the land, essential for continued productivity. Allowed deductions for land clearing, leveling and wetland drainage; the water depletion allowance;

and capital gains treatment on the sale of "sodbusted" and "swampbusted" land further accelerate destruction of our valuable farmland.

These problems are discussed in detail in the Environmental Policy Institute report, "Resources, Farm Structure and Agricultural Tax Policy," which is included as Attachment A to our testimony. If we are to continue as a productive nation, we must recognize the environmental sensitivity of our farmland. We cannot allow our farmland to be squandered for short-term gain harvested through the tax code.

4. Energy. Tax expenditures for energy development amounts to more than $27 billion annually. Of this, more than $26 billion is expended on non-renewable nuclear and fossil resources. Even when the solar/conservation tax credits were in effect, only about $1 billion was being expended in this area.

A detailed report, "Energy Tax Policy and The Environment: The Need for Tax Reform," prepared by Environmental Action discusses the full range of tax incentives for energy development. It is included as Attachment B.

For nuclear power plant construction, 24 percent of the funds needed were derived from tax-oriented incentives in 1983, according to the Edison Electric Institute. In addition to the traditional use of the ITC and accelerated depreciation, utilities have recently taken increasing advantage of pollution control bonds. For example, filings by Georgia Power Co. suggest the company plans to finance at least 27 percent of its share of the Vogtle nuclear plant with tax-exempt bonds. Overall, tax expenditures for electric utilities amount to more than $12 billion a year.

Environmental concerns in the energy sector focus primarily on oil drilling impacts, mining reclamation, acid rain and the greenhouse effect and on nuclear safety and waste disposal related to nuclear power plants. The bias in the tax code in favor of these energy resources and against conservation and solar is unacceptable from an environmental perspective.

Tax expenditures for oil and gas development are of a similar magnitude--at least $12 billion annually. Of this about $2 billion is expended for expensing of intangible drilling and tertiary injectant costs which are addressed by S 1839.

Such subsidies encourage overproduction of these limited national resources, leading to a drain America first policy. With increased scarcity will come increased pressure to drill in environmentally sensitive areas--pressure already being felt in the Overthrust Belt. Once we move into a crisis mentality, environmental concerns will be undervalued. Now is the time to use our resources prudently.

S 1839 would eliminate the expensing of costs for intangible drilling and tertiary injection within the environmental zones. We support these provisions since they would help protect our national wildlife refuges and national forests from excessive drilling activity. However, these provisions alone ~~will not~~ be sufficient to overcome the imbalance in the present tax code which favors oil and gas development over conservation and solar.

We support the removal of all tax incentives for energy development so that the Internal Revenue Code will no longer determine our national energy policy. All energy producers, including solar and conservation, should compete on a "level playing field." Until this is done, solar and conservation credits must be retained.

Conclusion. We support S 1839 for its pathfinding recognition that the present tax code encourages destruction of environmentally sensitive areas. Yet this brief discussion of the environmental concerns in relation to the tax code indicates that the problems extend well beyond the reach of S 1839. We urge subcommittee members to consider these environmental concerns as you plunge into the turbulent sea of tax reform.

Attachment A

ENVIRONMENTAL POLICY INSTITUTE

RESOURCES, FARM STRUCTURE AND AGRICULTURAL TAX POLICY

by Jack Doyle, Director
Agricultural Resources Project

The economic condition of agriculture is critically important because farmers and ranchers hold more of the environment than any other single entity outside of the federal government itself. In terms of the care of our nation's soil, the quality of much of its water resources, and the management of pests in the environment, farmers and ranchers play an enormously important role. How they manage their individual operations and, in toto, the elements of the broader biosphere that affects us all, is of great concern to us.

Obviously, as an environmental organization we should be concerned about how the federal tax code affects farmers' use of land, soil and water. And we support changes in the tax code that would eliminate certain deductions for land clearing, leveling, and wetlands drainage, as well as others, such as abolishing the water depletion allowance, and ending the favored capital gains treatment on the sale of "sodbusted" and "swampbusted" lands that have been converted to cropland.

Yet there are also other provisions in the federal tax code that affect the use of resources somewhat more indirectly, but no less seriously in the long run. These are the provisions of the federal tax code that pertain to who owns the land that is being farmed or the livestock being tended, or how water is used for irrigation. These are the provisions of the tax code that affect the structure or organization of the farm system as a whole. These provisions affect how capital is employed in agriculture, what kind of management practices are used, and how long some operations are held.

Today we have wealthy investors sheltering income in cattle that they never see. Some investors don't know what kind or how many investment cattle they own, let alone where they are, what they are fed, or how they are cared for. This is not attentive agriculture or attentive food production in our view -- not what you would call close-to-the-land agriculture. Rather it is far-away food production, managed by accountant and computer, and in some cases, factory-scale mass production, pure and simple.

Generally, we take the position that the "more hands" involved in the direct tending and husbanding of food-producing resources, the better off those resources are likely to be. A widely-owned agricultural sector is what Congress and the Federal Government have espoused since the days of Thomas Jefferson, Abraham Lincolm, FDR, and, more recently, in the 1977 and 1981 farm bills. From the Homestead Act to today's beginning farmer assistance loans, the federal government has generally supported a widely-held family farm system of agriculture.

Yet the federal tax code appears to run counter to this long-standing federal goal of family farm agriculture; of many hands in the soil.

Agricultural economist Harold F. Breimyer of the University of Missouri has noted, for example, "In its peculiar pattern of preferences, the tax code shelters high-tax-bracket individuals who invest in farming enterprises while denying a boon to operating farmers, many of whom lack enough income to be above the zero tax bracket."

Breimyer also notes how current tax policies will contribute to future changes in farmland ownership. Much of the family farm landholding in this country today, he explains, has been financed by the inflation of the 1970s, and now deflation and devaluation threaten to force existing farmers to sell all or some of their land. Land-price deflation also denies landholding to new farmers with no other source of equity. Now that inflation will no longer pay for the farmer's land, Breimyer points to what he sees as the emerging source of capital for farmland financing -- tax sheltered investment. "Currently," he says, "income from farming denied the I.R.S. by tax shelters is almost twice the amount generated." If these conditions continue, he adds, "most capital in agriculture will be of sheltered origin. And the economic consequence will be to speed the trend to deny ownership of farmland to those who really farm it." On that course, we are sure to see further consolidation, larger farms, and fewer people on the landscape.

The tax advantages in agriculture today are not those that favor the moderate income farmer that lives on the land, is frugal with capital and machinery, and makes most of his income from farming. Rather, the tax advantages in agriculture today are for wealthy individuals, limited partnerships, trusts, insurance companies, and non-farm corporations looking for tax shelters and speculative investments. However, these tax investment opportunities do not promote stability in agricultural ownership or stewardship in resource management. Instead they promote expansion and capital-intensive agriculture for tax purposes, overproduction of certain farm goods, higher farm program costs, volatile markets, and erosion of small-town agricultural economies.

It is perhaps one of the cruelist ironies of our tax code that makes farming a better tax investment for wealthy people who never set foot on a farm, than it does for working farmers who have given their lives to tending the soil, husbanding livestock and producing food for the rest of us.

Today, tax-code induced absentee investment in agriculture is reaching new levels of sophistication, with very serious ramifications for resources and farm structure. Consider a few examples.

The Prudential Life Insurance Company

In 1979, the Prudential Life Insurance Company bought 23,000 acres of land in Jasper and Newton Counties in northwest Indiana. The company then proceeded to bring in heavy land-clearing equipment, leveled the land, removed old stands of trees, drilled deep wells, installed 50 center-pivot systems, and began growing corn. But what Prudential is really doing in Indiana, and presumably elsewhere in the United States where it owns more than 600,000 acres of agricultural land, is farming the tax code.

At practically every step in this farm development process there is a tax break. Clearing land is a capital improvement, entitled to one tax deduction. Irrigation systems, tractors and other new work-related equipment get a 10 percent deduction initially, and over 5 years, additional costs can be deducted.

This Prudential "farm," in Indiana is now consuming about 1.25 billion gallons of water annually from underground aquifers, impacting the water supplies and water quality of neighboring and nearby family farms, causing large sinkholes on neighboring land, and generally affecting everything from nearby soybean yields to the local populations of muscrat and quail. And to add insult to injury, Prudential's operation, because it is irrigated, is eligible for federal price supports at rates one-third higher than non-irrigated.

First Continental, Inc.

First Continental, Inc. of Billings, Montana is a farming corporation run by John Greytak, a Montana businessman. Over the last 5 years or so John Greytak, through several limited partnerships, has broken out more than 250,000 acres of grassland in Montana and South Dakota and planted it to wheat. These operations, mostly found in Custer, Petroleum and Bighorn counties in Montana, are typically large block-farming operations, with wheat planted over the ridge, on the hillsides, and through natural drainages. The intent of these limited-partnership farming operations is to offer a tax shelter to their wealthy limited partners, some of whom are California doctors and lawyers. Yet along the way, there is money changing hands and business activity spurred by the tax code. Aetna and John Hancock insurance companies seem to be involved in financing some of Greytak's operations.

There are also investment tax credits, depreciation allowances and land leveling credits. And there is also a potential gain to be made as grassland converted to cropland increases in value, and when sold, is taxed at a 40% rate. And after several years of farming these operations for their various working tax advantages, they are typically put up for sale. But when such land is thrown on a depressed market without any buyers, it is left fallow, and in Montana, to blow away in the wind.

Absentee Investors & Soil Erosion In Colorado

Canadian investors broke out grassland in Weld County, Colorado in 1980, contributing to wind erosion that later buried fences, covered adjoining ranchland, and darkened the sky. In Cheyenne County, Colorado, the White Horse Investment Co., -- a corporation headquartered in the Netherlands Antilles with two financial partners in Panama City -- broke out more than 5,000 acres of rangeland between 1980 and 82 and planted it to wheat. Much of this land has also eroded.

Phoenix Mutual Life Insurance Co.*

The Phoenix Mutual Life Insurance Co. has established a limited partnership, open to investors for as little as $2,500, that invests in U.S. farms and farmland. In these arrangements, the general partner, Phoenix Farmland Management, Inc., buys corn and soybean farms primarily in Illinois, Indiana and Ohio that

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*See, for example, "Old McDonald Had... A Limited Partnership?," *Business Week*, May 21, 1984, p. 153.

range in size from 40 to 320 acres, and then leases these operations back to farmers. As of May 1984, Phoenix Mutual had raised $5.5 million in one such partnership, which appeared to include money from IRA and Keogh plans. This means that major insurance companies are now leveraging money from less wealthy investors to use in tax-loss farming operations.

Bass Brothers Expand Into Hog Confinement

The Bass brothers of Fort Worth, Texas, an oil family renowned for its wealth and speculative activities, owns a Kansas City based corporation named National Farms, Inc. National Farms operates a 75,000 head confinement hog-feeding operation in the Sandhills region of Nebrasks; an operation which is now being expanded to accommodate an additional 300,000 hogs. In the past, as much as three-fourths of the hogs in this facility were owned by Tysons Foods.

Cargill, Inc.

Cargill is the world's largest grain trader, the nation's second largest beef packer, and its 5th ranking seed producer. This privately-held company is also involved in soybean crushing, oilseed processing, and produces and sells fertilizers and livestock feeds.

With the help of the tax code, and specifically through various income and cost-accounting devises, Cargill has also become one of the nation's largest cattle feeders. The company feeds its own cattle, as well as cattle owned by other investors and company customers, at its Caprock feedlots in Kansas and Texas.

Not long ago, with booming agricultural exports and rampant inflation of the 1970s, insurance companies, land speculators and foreign investors were buying up American farmland where they could.* Part of that bubble burst, however, with the hard

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*Insurance companies and investment firms have been attempting to fashion various forms of farmland investment trusts and tax shelters since the mid 1970s. Perhaps the most famous of these came in 1977 when Continental Illinois Trust Company of Chicago attempted to secure federal approvals for a unique farmland investment plan called "Ag-Land Fund-I." This fund was designed as a mutual fund that would invest solely in working farms which contained at least 75% of Class I and Class II farmland soils -- that is, prime row-crop farmland typically producing corn and soybeans. The initial investment in this fund was pegged at $50 million, to be marketed by Merril, Lynch in $100,000 shares to trustees of pension funds, profit sharing trusts and other tax-exempt institutions. The Ag-Land Fund's stated purpose was "to invest in U.S. agricultural land primarily for appreciation and secondarily for current cash return...." The fund sought to invest in working farms in three general locations: western irrigated lands, lands from the Mid-South, and land from the Midwest. The land would be farmed under a system of leases or sharecropping arrangements, and the fund would derive income from lease payments, crop earnings and expected appreciation of land values.

The U.S. Comptroller of the Currency had approved an exceptional agent's fee for Merrill Lynch under the fund proposal, and the SEC allowed that the fund would not have to realities of the 1980s -- disinflation, high interest rates, and sagging export markets. But the value of land is now nearing rock bottom, according to some market analysts, and the tax shelters in agriculture are still as ripe as ever for tax-loss farming, if not more so. Huge blocks of agricultural land and bad agricultural paper is there for the taking by any enterprising investor or financial institution.

Oppenheimer Industries, Inc.

According to Barron's, Oppenheimer Industries of Kansas City, is "one big manager of investor-owned farmland." But now Oppenheimer is devising a new farmland investment portfolio

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*(footnote continued) register as an investment company. Continental Illinois was also asking the IRS for a tax-exempt status. Moreover, since the fund was proposed as a qualified trust rather than a corporation, it would be exempt from state anti-corporation farm laws. The Ag-Land Fund-I proposal generated considerable controversy among farm groups, but was closely watched by the financial community. After pressure from Secretary of Agriculture Bob Bergland, and hearings held on the proposal by a House Agriculture Subcommittee on Family Farms, Rural Development and Special Studies, Continental Illinois withdrew its plan. However, other plans soon emerged.

In 1980, three former executives of the Northern Trust Co. of Chicago formed a corporation to purchase prime farmland for pension fund investors called American Agricultural Investment Management Co., Inc. And just this year, a new trust, named Consolidated Family Farms, has formed to buy up foreclosed farms.

Under the plan, Oppenheimer's trust would specifically buy up foreclosed-upon farm operations from banks and insurers with money raised from high-income shareholder/investors. These farms designed tc take advantage of the current decline in farmland prices, offer a tax shelter to high-income investors, and help put a better face on some farm mortgage notes currently in decline and held by insurance companies and banks. Oppenheimer's plan is a real estate investment trust, or REIT for short. would be leased back to local farmers or managers, and held by the trust for 10 years, after which, presumably, an appreciation in value and profits for REIT shareholders will result. Meanwhile, two-thirds of the money invested in the trust will be placed into Treasury securities and other government-backed paper, while some of the rest is used to manage the farms. There are more details on the terms of agreement between the farm-selling institutions (banks and insurers) and the trust, and how the pie is split up when the land is sold and the trust liquidated, but here again, the tax code is helping to provide an investment opportunity for wealthy investors that may hasten foreclosure actions against family farmers and eventually, farm consolidation in the U.S. farm system.

The Demise of "Attentive Agriculture"

By contributing to the demise of family farm agriculture and favoring the largest producers with more generous tax write-offs, the tax code is contributing to the demise of what we call "attentive agriculture" -- a system of people who live on or near their operation and who care something about the way its resources are used and managed as well as how it is regarded in the local community.

Consider, for example, what the tax code is doing to "attentive" family-based hog production. Every good hog farmer knows that you get stronger litters when breeding sows are kept for four or five farrowings instead of one or two. Yet the tax code encourages large-scale confinement producers -- (which are in business, in part, and gain a competitive advantage over smaller operators because of the investment tax credit on single-purpose structures and accelerated depreciation rules) -- to sell their breeding sows after one or two farrowings. The capital gains treatment on the sale of breeding stock can help reduce tax liability when expenses related to keeping the sow are deducted. So an incentive is created to sell the sow in the short run rather than keep her around for more than one farrowing. But university studies indicate that the more mature sow has better rates of conception, is a better mother, and yields bigger and stronger offspring.

The tax code, in other words, works in contravention of these findings. It encourages that kind of hog production which works against the natural (and what seems to be the most efficient) tendencies of farm animals. In this sense the tax code is re-enforcing a kind of economic behavior that runs counter to the natural rhythms of land and genes; creating economic incentives which work to eliminate true husbandry and efficiency from agriculture, rather than encouraging them.

In fostering large-scale-integration in agricultural production, and increasing the use of capital and technology in agriculture, the tax code has helped make agriculture less attentive to resource abuse and side effects. I think it can be fairly said that the tax code -- inasmuch as it has fostered and continues to foster farm consolidation, favored commodity production, and livestock confinement -- has contributed to more monocultural cropping, larger livestock and poultry operations and with these developments, more intensive use of pesticides, antibiotics, and medicated feeds. All in all, this is a great boon for agricultural supply businesses of all kinds, but maybe not a boon for long-term public health and environmental quality.

It makes perfectly good sense for the federal government to use the tax code to create incentives for putting surplus capital to work in ways that will benefit society. Yet after examining what the tax code has done in agriculture, we can only conclude that it has, perhaps irrecoverably, contributed to the ruin of diversified farming in certain regions, created troublesome surpluses in favored tax-dodge commodities, needlessly abused and depleted valuable food producing resources, and undermined the social and economic fabric of many rural communities. Perhaps that is why the Des Moines Register has recently called agricultural tax policy the "quiet killer."

In the interest of sound conservation practices, better farm income, and economic stablity for family farm agriculture, EPI supports the following changes in agricultural tax policy:

- eliminate the deductions for land-clearing, leveling and draining
- retain the deduction for conservation expenses, but define eligible investments to include only those which reduce soil erosion
- eliminate the water depletion allowance
- eliminate the capital gains treatment on the sale of "sodbusted" or "swampbusted" land converted to cropland
- place single-purpose agricultural structures in the structure depreciation category
- eliminate the investment tax credit
- eliminate capital gains treatment of breeding stock and depreciable property,
- allow the deduction of costs of raising orchards, dairy

cows, and breeding cattle but only if they are added to inventory (with possible allowances for transition period)

- for taxpayers using cash accounting, limit current deduction of inputs for use in following years to 25 percent of such inputs used annually or the national median income, whichever is less. Limit deduction of farm losses from nonfarm income to the national median income minus the amount by which the taxpayer's income exceeds twice the median.

As noted earlier, we believe that agricultural tax policy -- consistant with long-standing government agricultural policies -- should encourage wide ownership and a farm sector with many competing producers. Yet just the reverse seems to be happening. Fewer and fewer non-farm entities are accounting for more and more of the food and fiber produced in this country, and these producers are having a substantial influence in commodity organizations, some farm groups, and in the political process. When one U.S. Senator reports -- as he did recently in the Des Moines Register -- that his 1984 legislation for slowing the depreciation on single-purpose livestock and poultry buildings would have been blocked on the floor of the U.S. Senate by another senator working at the behest of one poultry producer, that appears to us as disproportionate influence, and is certainly a distortion in the democratic process. As it turned out in this particular case, the proposed provision was inserted when the objecting Senator was absent, but he and a few Texas Congressmen representing tax-shelter cattle farmers eliminated the provision in conference committe.

By fostering economic concentration in agriculture through the tax code, we may well be fostering what some would call efficiency, but we are certainly also encouraging certain kinds of vulnerability -- political and otherwise. As every Wall Street advisor who has counseled the wise course of diverse portfolios knows, putting all your eggs in one basket is not a good idea. With the tax code, we need to create incentives for agricultural diversity and economic opportunity, reducing the inherent danger of too many eggs in one basket.

Attachment B

ENERGY TAX POLICY AND THE ENVIRONMENT: THE NEED FOR TAX REFORM

Ruth Caplan, Executive Director
Environmental Action

Federal tax policy has an enormous impact on the way energy resources are developed and used in the United States. The federal government loses more than $27 billion in revenue annually through tax benefits for the development and production of energy resources, according to a recent study by the Environmental Action Foundation (EAF). All but a small fraction of the identifiable tax expenditures for energy development are for non-renewable resources such as oil, gas, coal and uranium, as well as for conventional electricity production facilities. Table 1 lists these tax expenditures.

The current federal income tax code encourages wasteful use of limited energy resources and promotes the use of energy technologies which have adverse environmental impacts. It encourages energy investment decisions which are made largely on the basis of expected tax benefits rather than economic efficiency. By favoring development of non-renewable energy resources, it discourages more environmentally benign ways of meeting our energy needs such as renewable energy sources and energy efficiency improvements. In our view, existing federal tax policy is a major cause of our nation's wasteful and environmentally unsound energy development practices.

GENERAL CORPORATE TAX BENEFITS FOR ENERGY

Several investment incentives available to all businesses by the tax code are of particular importance to the capital-intensive energy industries. These include the accelerated cost recovery system (ACRS), the investment tax credit (ITC), and the use of tax-exempt industrial development bonds.

Accelerated Cost Recovery System. The Accelerated Cost Recovery System (ACRS) benefits enable energy firms to postpone paying more than $10 billion of their tax liability annually. Electric utilities defer about $5 billion annually through ACRS benefits. Oil and gas interests defer an estimated $6 to $10 billion annually, according to estimates by EAF.

ACRS has been roundly criticized by the Treasury Department because it "creates an artificial incentive for one form of investment over another...and encourages nonproductive, tax-motivated investment activity." Further, Treasury I argues, "ACRS disproportionately benefits capital-intensive industries and methods of production." (Tax Reform for Fairness, Simplicity, and Economic Growth, v. 2, pp. 154 and 156)

Investment Tax Credit. Nearly all investments in energy facilities qualify for the 10-percent investment tax credit, including power plants, oil refineries and coal mining machinery. The ITC provides at least $5 billion annually in subsidies for energy investments, mostly to oil companies and utilities.

This tax subsidy favors costly energy investments such as nuclear plants and oil refineries over less capital-intensive technologies. The ITC can reduce the cost of building a new nuclear plant by as much as half a billion dollars.

The ITC has become an enormous capital subsidy for the energy industries, encouraging investments which might not be made but for this tax benefit. Economist Don Fullerton of the University of Virginia argued in testimony last spring before the House Subcommittee on Economic Stabilization that the original justification for the investment credit has disappeared and that businesses' "own efficient allocation decisions are distorted" by this subsidy. We agree and are pleased to see that all the major tax reform proposals would eliminate this subsidy.

Pollution Control Bonds. The energy sector has made heavy use of industrial development bonds (IDBs) due to a provision passed in 1968 which allows private businesses to use IDBs to finance pollution control facilities. Because they offer a low-cost source of capital, pollution control bonds have become an important vehicle for financing new energy investments, particularly electric power plants.

Use of pollution control bonds for energy facilities has increased dramatically in recent years. During the first nine months of 1984, 86 percent of all pollution control bonds issued were used to finance energy facilities, and 84 percent were for power plants. Pollution control bonds for energy facilities outstanding at the end of 1984 cost the the federal Treasury approximately $1 billion in 1984. New pollution control bonds issued for energy facilities in 1984 alone will cost the Treasury $6 billion over the next 30 years. (The net present value of this revenue loss is $2.5 billion, assuming a 10-percent discount rate.)

Instead of protecting the environment, pollution control bonds actually encourage investments in polluting technologies. These tax-exempt bonds are used mainly to build new facilities rather than to clean up existing ones. Moreover, they are available only for pollution controls which are already required by the Environmental Protection Agency. Pollution control bonds may also encourage capital-intensive approaches to pollution control when other approaches are more cost-effective.

SPECIAL ENERGY TAX BENEFITS

Expensing. Under the current tax code, the costs of financing a new long-term asset are generally not deductible currently but must be capitalized and then deducted or amortized over a period of years. Energy investments, however, derive substantial tax benefits from exceptions which are made to this rule.

Expensing of Construction-Period Interest. For certain personal property, including energy facilities, present law allows a current tax deduction for interest on funds borrowed to finance construction. Expensing of construction-period interest allows an energy firm to receive a large tax deduction up front, long before its new investment is producing income. This represents an interest-free loan from the Treasury for long-term construction projects such as power plants and offshore oil rigs.

Electric utilities alone saved $4.1 billion on their 1983 tax returns by expensing construction-period interest, according to calcuations by EAF. The extent of savings by the other energy industries is not known, but is probably quite substantial.

Expensing of Intangible Drilling Costs. Few provisions have received as much attention in the press as the expensing of intangible drilling costs, (IDCs). Under the law, a taxpayer can take an immediate write-off of 80 percent or more of their IDCs, rather than having to capitalize the cost of productive wells and write off unproductive wells over time as a business loss.

Expensing of Exploration Costs. As with oil and gas, most exploration and development costs for hard mineral energy resources such as coal and uranium can be expensed currently, instead of being capitalized. The total benefit is much smaller for coal than for oil and gas drilling ($110 million in 1983 compared to more than $2 billion for oil and gas).

Percentage Depletion. Under this 1926 provision, depletion is based on the size of the reserve, not on the cost of production. As a result, the total depletion claimed for tax purposes may be many times the original investment.

Deductions for Mining Reclamation Costs. Mining companies are permitted to take current deductions for future reclamation costs, even if they do not set aside funds for that purpose. Mining companies are thus allowed about $400 million annually in advance deductions for reclamation costs, even though there is no assurance the land will be reclaimed. Deductions for such costs are justified only when they are actually incurred or when funds are set aside for that purpose. In an analogous situation, a 1984 law allows utilities which operate nuclear reactors to take current deductions for future decommissioning expenses, but only if funds are actually set aside for this purpose.

Capital Gains Treatment of Coal Royalties. Income earned on royalties from coal production is eligible for capital gains treatment. This provision saves coal interests $110 million annually, according to Treasury.

Limited Partnerships. Nearly one million individuals had limited partnership investments in oil and gas in 1982, according to Treasury. This represents about one-third of all limited partnership investors. This tax loophole encourages investments in oil and gas; and because such investments need not be profitable, it may encourage frivolous drilling activity. The exact level of tax expenditures due to limited partnerships in the energy sector is difficult to determine and is not included in Table 1.

Benefits for Synthetic Fuels. Synfuels investments can benefit from more than 10 different subsidies in the current tax code. Capital subsidies such as the ACRS and ITC provide an important boost to all synfuels projects. In addition, any synfuels products which are derived from coal benefit from all of the tax subsidies available for coal development.

Synfuels can also benefit from as many as five additional subsidies, according to a Congressional Research Service report. Any synfuels project which had an affirmative commitment in 1982 qualifies for a special business energy tax credit. Certain synfuels projects may also qualify for financing with tax-exempt industrial development bonds. Producers receive a special tax credit for every barrel equivalent of synthetic fuel they produce. Synfuels products are also exempt from federal excise tax on fuels, and income from synfuels is exempt from the windfall profits tax. Despite the large number of tax benefits available for synfuels development, the cost to the Treasury is still relatively small because few such projects have been undertaken. Nevertheless, if left in place, tax subsidies could make synfuels development appear profitable, resulting in substantial environmental and economic costs to our society.

TAX BENEFITS FOR ENERGY EFFICIENCY AND RENEWABLE ENERGY SOURCES

The business and residential energy tax credits for renewables and conservation adopted by Congress in 1978, were an attempt to give these newly developing energy sources a chance to compete with the already established and heavily subsidized non-renewables. With a few exceptions, all of these benefits expired at the end of 1985. By contrast, the major tax subsidies for non-renewables have become a permanent fixture in the tax code.

The total cost of federal tax expenditures for energy efficiency and renewable energy development is between $600 million and $1.5 billion for FY85. The actual cost is difficult to determine because Treasury does not identify ACRS, ITC, or business energy tax credits used for renewables and conservation separately from synfuels and coal conversion. If we assume that half of the business energy tax credits are used for renewables and conservation, the total federal tax expenditure for these technologies in FY85 would have been about $1 billion. That compares to more than $26 billion in tax expenditures for the development of non-renewable energy resources.

TREASURY I: REMOVING THE TAX CODE FROM ENERGY POLICY

In sharp contrast to the long list of provisions just described, Treasury I can be described very briefly: none of the above. If adopted it would be a major step toward a "level playing field," with energy investments being made according to their economic merits, rather than being based on maximizing tax subsidies. For all the reasons we have criticized the present tax code, we would welcome Treasury I.

While the environmental community strongly supports the extension of solar and conservation tax credits, a number of organizations, including Environmental Action, have publicly supported the energy provisions in Treasury I, even though it would repeal these very credits. We believe that conservation and renewables will prove to be economically competitive without tax breaks, if all tax and budget subsidies are removed for all energy sources. That means all energy tax subsidies described above should be phased out, taking H.R. 2001 and S. 1220, "The Renewable Energy and Conservation Transition Act of 1985," as a model.

TAX EXPENDITURES FOR ELECTRIC UTILITIES

Because of the large investment required to build a power plant, electric utilities make extensive use of investment credits, ACRS, expensing of construction-period interest, and tax-exempt pollution control bonds. In addition to these general capital subsidies, the federal tax code provides special tax benefits for the use of tax-exempt bonds for the local furnishing of electricity.

Tax expenditures for electric utilities cost the federal Treasury over $12 billion annually, according to calculations by EAF. Tax benefits provide electric utilities with enormous subsidies for building new power facilities. The Edison Electric Institute, the utility trade association, has stated that in 1983, "24 percent of the funds needed to meet our industry's construction requirements were derived through the utilitization of these tax-oriented incentives."

Accelerated Cost Recovery System. The largest utility tax subsidy comes from the generous depreciation provisions passed in the 1981 tax act, which amounts to about $5 billion annually. A 30-year investment in a coal-fired power plant, for instance, can be written off in just 15 years because of the shortened tax life provisions of ACRS. Moreover, because depreciation can also be accelerated during that period, most of the plant can be depreciated in about six and one-half years. Nuclear plants receive even more favorable treatment, with a tax life of just 10 years. Under ACRS, most of a 30-year nuclear investment can be written off in just four years.

Besides encouraging new investments, ACRS provides a strong incentive for businesses to expand continuously. A growing firm can keep postponing payment of its deferred taxes since tax benefits from new investments offset old tax liabilities which come due, a fact confirmed in the National Research Council's 1980 report "Energy Taxation: An Analysis of Selected Taxes."

The current ACRS system results in "misallocation of resources," as Dr.

Fullerton testified. "Special investment tax credits and accelerated depreciation allowances serve to push economically inferior investment projects ahead of more productive investment projects," he observed.

Investment Tax Credit. The ITC provides utilities with 10 percent of the capital required for building new plants. The National Research Council report explains how the ITC distorts planning by electric utilities:

> [T]he investment tax credit makes the high capital cost option cheaper to investors than is justified by the resources actually expended. It thus tends to induce choices that absorb more capital in generating the same amount of electricity than would be the case without the tax credit. (p. 80)

Even if there were economic justific~~ation for~~ capital subsidies such as ACRS and ITC, there is little reason for such tax expenditures for regulated utilities. As then House Ways and Means Chair Al Ullman stated in 1962:

> In view of the fact that utilities are regulated monopolies with guaranteed rates of return and with a utility responsibility to provide all the investment needed to meet demand, I can see absolutely no reason for offering them a tax incentive to do what they are required to do anyway. (108 Congressional Record 5319, 1962)

If indeed these capital formation incentives are effective, they encourage utilities to make unnecessary investments, to the detriment of our economy and the environment.

Expensing of Construction-Period Interest. As explained earlier, electric utilities save more than $4 billion annually from this provision, the second highest tax subsidy they receive.

Pollution Control Bonds and Other IDBs. Electric utilities issued at least $4.8 billion in pollution control bonds during 1984, which provided more than 30 percent of the industry's external capital for new investment.

Pollution control bonds have typically been used to finance 10 to 20 percent of the cost of a coal-fired plant, less for a nuclear plant. A recent ruling by the Internal Revenue Service, however, enables utilities to finance an even larger portion of their nuclear investments with tax-exempt bonds. Filings by Georgia Power Co. suggest the company plans to finance at least 27 percent of its share of the Vogtle nuclear plant with tax-exempt bonds. The utility would thus save about $1 billion in interest costs over the plant's lifetime.

Another provision allows utilities to use tax-exempt industrial development bonds to finance construction of facilities which will provide electricity or gas to not more than two counties. This provision has enabled a few utilities, such as Hawaiian Electric Co., to finance entire new plants with tax-exempt bonds. In 1984, Congress stretched this provision further to allow Long Island Lighting Co. to use tax-exempt bonds to refinance the debt on its troubled Shoreham nuclear plant.

Impact of Tax Subsidies on Utility Investment. Federal tax subsidies contribute to the poor planning and wasteful investments which have characterized the electric utility industry in recent years. After more than a decade of overbuilding, the utility industry has a generating reserve margin of 36 percent --about twice what regulators recommend. Because they overestimated power demands and underestimated construction costs, utilities have been forced to abandon more than $25 billion invested in nuclear plants which were never completed. Construction is continuing today on about 30 nuclear plants which will produce power at rates far above the cost of alternatives.

Without the massive federal tax subsidies for new investment, utilities would be forced to pursue more creative ways of meeting their customers' energy needs, such as load management and energy efficiency improvements. An official of Consolidated Edison Co. has stated that a loss of federal tax benefits for utilities would stimulate "less capital intensive forms of energy development" and that conservation and load shifting may become more appealing than new power plant construction. (Electric Utility Week, December 3, 1984) It is not unreasonable to conclude that without the generous federal tax subsidies it has received over the past few decades, today's electric utility industry would be very different.

CONCLUSION

The current patchwork of energy tax subsidies plays havoc with rational energy policy, wasting both economic and natural resources. It prevents individual decisions regarding energy production and use from efficiently allocating economic and natural resources. Further, it distorts the true environmental costs of resources, resulting in unnecessary environmental impacts.

Treasury I would eliminate virtually all tax subsidies for energy, an important step toward creating a "level playing field" for energy investments. From an energy perspective, it provides the bench mark of tax reform. No other tax reform proposal is as comprehensive.

If the tax code is to continue to be used to set energy policy, then it should be done on the basis of a careful examination of the broad range of issues relating to energy use and production. Tax incentives should not run counter to principles of least-cost energy planning and efficient allocation of resources.

TABLE 1

ANNUAL FEDERAL TAX EXPENDITURES FOR ENERGY DEVELOPMENT

Electric Utilities	**Present Law** (in billions of dollars)
ACRS	4.73[a]
Investment tax credit	1.96[a]
Expensing of construction-period interest	4.10[a]
Pollution control bonds (approx.)	1.00[b]
Other industrial development bonds	0.18[c]
Dividend reinvestment programs	0.45[c]
TOTAL (approx.)	**12.42**
Oil and Gas	
ACRS	6.00-10.00[d]
Investment tax credit	3.00[d]
Percentage depletion	1.12[c]
Expensing of intangible drilling	2.03[c]
Expensing of construction-period interest	?
Expensing of tertiary injectants	?
Tax benefits for foreign operations	?
TOTAL (approx.)	**12.15-16.15**
Coal	
ACRS	0.35[e]
Investment tax credit	0.18[e]
Percentage depletion	0.60[e]
Expensing of exploration costs	0.11[e]
Deduction for future reclamation costs	0.40[c]
Capital gains treatment of royalties	0.11[c]
TOTAL	**1.75**
Renewable Energy Efficiency and Synthetic Fuels	
Residential conservation	0.33[c]
Residential renewables	0.24[c]
Alcohol and synthetic production credits	0.02[c]
Business energy tax credits (incl. wind, solar, hydro, geothermal, biomass, synfuels and coal conversion)	0.21[c]
Investment tax credit (approx.)	0.17[d]
ACRS[f]	
Renewables	0.33-0.45
Synthetic fuels & coal conversion	0.33-0.45
TOTAL TAX EXPENDITURES FOR ENERGY	**27.63-31.78**

Notes for Table 1:

a. US-Department of Energy for 1983.
b. Environmental Action Foundation estimate for 1984.
c. U.S. Treasury for FY 1985.
d. Environmental Action Foundation estimate for FY 1985.
e. National Coal Association for 1983.
f. Treasury data combines renewables and conservation with synthetic fuels and coal conversion. For purposes of this table, half of the ACRS is allocated to renewables;conservation and half to synfuels and coal conversion.

Sources for Table 1:

U.S. Department of Energy, Energy Information Administration, Financial Statistics of Selected Electric Utilities 1983, February 1985.

The Bond Buyer, December 4, 1984.

Ebasco Business Consulting Co., Analysis of Public Utility Financing, Year 1984, January, 1985.

U.S. Office of Management and Budget, Special Analysis G of the Budget, Fiscal Year 1986, February 1985.

Internal Revenue Service, Statistics of Income: Corporation Income Tax Returns, 1981, 1984.

Carl E. Bagge, National Coal Association, letter to Secretary Donald P. Hodel, U.S. Department of Energy, December 14, 1984.

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Senator CHAFEE. I am delighted to see a very distinguished member of this full committee and subcommittee, Senator Wallop from Wyoming. Senator, do you have a statement you want to put in no,?

Senator WALLOP. John, I do, and if I may read just a little of it?

Senator CHAFEE. Surely. Now is the time.

Senator WALLOP. Mr. Chairman, to my regret, I view this bill as a misuse of the tax law. Although the concept and purposes of S. 1839, according to the distinguished sponsor, are to make our tax policies and a number of tax incentives that we have enacted in our Tax Code consistent with some of our environmental policies, or national goals or objectives, the bill is in fact not consistent with environmental policies or national goals and objectives.

Specifically, the 195-million plus acres of the national forest system are not only natural areas of ecological significance, they are by law much more, as stated in the National Forest Organic Act, the Multiple Use and Sustained Yield Act of 1960 and other acts.

If I can, let me just quote from the Multiple Use and Sustained Yield Act of 1960:

> It is the policy of the Congress that the national forests are established and shall be administered for outdoor recreation, range, timber, watershed, and wildlife and fish purposes. The purposes of the act are declared to be supplemental to, but not in derogation of, the purposes for which the national forests were established, as set forth in the act of June 4, 1897. Nothing herein shall be construed so as to affect the use or administration of the mineral resources of the national forest lands or to affect the use or administration of Federal lands not within the national forests.

And I have another quote from it, which I won't read, but would ask to be included in my statement which goes to the definition of 'multiple use and sustained yield.' And I cite that rather lengthy law in order to point out that Congress has consistently determined through its constitutional duties to make sure that the Federal land allocation decisions carefully apply to the degrees of resource protection necessary. We do this by a system of land classification that is highly stratified. We established a national forest and in natural areas, where after careful study and debate we may add or designate wilderness status to preclude unwanted development. We have areas in the National Park System and in the National Wildlife Refuge System where we carefully allow and support limited extraction of minerals, surface development, limited agriculture, and other activities that would have punitive tax treatment under this measure.

The concept so successfully applied by you, Mr. Chairman, in the barrier islands leqislation does not extend well into this issue. In the case of the barrier islands, we did not want one Federal policy where action could cancel or hinder another. In the barrier islands, we have no basic land allocation; but instead, Federal intent not to encourage unwanted development by fiscal involvement. Congress, through the appropriate committee, has a well-recognized and workable system of protection of species, areas, lands, and waters with a diverse and specific management regime to accompany the land classifcation. This bill, through its withholding or withdrawing of tax authority, imposes a land classification system with no discernible bounds; any which can be discerned are certainly beyond those which Congress has designated.

This bill, S. 1839, if enacted, sets a sixth system of land classification in place to supplant the National Forest System, National Park System, National Wildlife Refuge System, the National Wild and Scenic River System, and the National Wilderness Preservation System. I think these decisions are better made in the appropriate authorizing committees upon which we serve. We can, in the traditional way, do the necessary and the specific in limiting, defining, and controlling unwanted uses, and do the required job of resource protection with a precise scalpel and not the shotgun of a tax law change.

Senator **CHAFEE**. Thank you very much, Senator. I appreciate so much your coming here. I know you are deeply interested in these areas, and we look forward to your contributions as we give consideration to this.

I have a couple of questions for Ms. Campbell and Ms. Newsome, and I guess Ms. Babcock, where you talk about the wetlands. As you know, there are a few matters that I am more interested in than preservation of wetlands in our Nation. The problem we have had with this is delineating what is a wetland; and we have tried various approaches. As you recall, Secretary Watt had some legislation on this.

And we have worked from satellite photos and all kinds of attempts. Do you have any suggestions that could help us, Ms. Babcock?

Ms. **BABCOCK**. Yes; I think for one, the farm bill that was passed last year, contains a definition of wetlands that perhaps could be used here. It is really the first legislative definition of wetlands we have had. Alternatively, you could refer to the Fish and Wildlife Inventory and the mapping process and whatever they have put on their maps and use that classification system. I think there are available sources of a definition that are reasonable and could be used.

Senator **CHAFEE**. Ms. Campbell.

Ms. **CAMPBELL**. I will defer to Ms. Newsome.

Senator **CHAFEE**. All right. Ms. Newsome.

Ms. **NEWSOME**. I would just suggest that you ought to look at the Army Corps of Engineers 404 Permitting System which, if an area is a wetland, they need to get 404 permit. That would define the area which also would not be eligible for Federal tax——

Senator **CHAFEE**. If there is any suggestion that this legislation wasn't controversial, that would complete it. [Laughter].

Ms. **NEWSOME**. We want you to look very moderate, Senator Chafee. [Laughter.]

Senator **CHAFEE**. I know all the witnesses here have been interested in the barrier beach legislation which I have and which Senator Wallop mentioned earlier. This is a little astray from this legislation before us. Have you found, Ms. Newsome—and I think you mentioned this in your testimony, that it is a little early to tell—have you found that has slowed down development? Have we been successful? As you know, that legislation doesn't keep anybody from building. It just says we are not going to help subsidize them; and I was wondering what your researchers found. I suppose a particularly effective part of it all probably was the denial of the flood insurance.

Ms. **NEWSOME**. Only anecdotal evidence, Senator Chafee; and it appears that in those areas that were adjacent to already developed areas. They ,ere not islands. They were not largely separated from developed areas; that there is a continuing development effort going on. One of the things that is attractive about S. 1839 is that, as interest rates have gone down, we have seen a surge of development on coastal barrier units, particularly close to already developed areas. So, I think that your bill is very important in that particular system in establishing a level playing field in the marketplace.

Senator **CHAFEE**. You mean this bill here?

Ms. **NEWSOME**. Yes.

Senator **CHAFEE**. One of the concerns that was voiced to me by an interested party in my State, who supports this type of legislation but was concerned about a situation such as in Lowell, MA, which itself is a park area, as I understand it. The feeling was that this type of legislation inadvertently would be harmful to that park which takes extensive advantage of the historic tax credits, for example, and I suppose the investment tax credit and depreciation. What do you say to that? Mr. Sellers.

Mr. **SELLERS**. Senator Chafee, I agree that that is probably a problem the way the bill is now; but I am sure you plan to make some changes. That is why I was also suggesting that there is a need for some sort of a review procedure. In part, my reason for that is our own experience with IRS is that they are not good conservation people, and I don't think they want to be. But also, because I do think you need the comments from the National Park Service or National Wildlife Refuge managers and that sort of thing.

Senator CHAFEE. Anybody else like to comment on this?

Mr. BROWN. Senator Chafee, I think that is a good point as well. You might consider a provision in the bill that would establish a rebuttable presumption that the tax credits and deductions are not available—a presumption that could be rebutted if the taxpayer could demonstrate to Treasury, perhaps on the advice of resource management agency that, in fact, the activity is beneficial, or is not adverse.

Senator CHAFEE. All right. Senator Wallop, do you have any questions now?

Senator WALLOP. No, Mr. Chairman; except that I would observe that there is a history of production, for instance, of oil and gas extractions in extremely sensitive places which have been quite compatible with the sensitivity of the place. Not the least of which is in the Aviary Island area, in the Aransus area; indeed, the National Audubon Society's own sanctuary has been cited as a very specific, a very laudible example of the development of two resources simultaneously.

It seems to me that when you have that example in hand, and yet another classification on top of it, you are merely adding burdens to a system which has the ability to work well. That is a just a comment and observation, but I think this is what this bill is trying to achieve. It is perhaps not necessary; perhaps there are other means that are (a) more efficient and (b) less detrimental to the broad sustenance of the national economic climate.

Senator CHAFEE. Mr. Brown.

Mr. BROWN. Just a brief comment. I appreciate the Senator's concerns, especially in respect to national forests and wildlife refuges which have a broader range of uses, but bear in mind that the bill as introduced does not limit tax credits and deductions, as I understand the bill, for areas that have already been designated wildlife refuges or national forests. The purpose is to extend protection from tax subsidized development after the Congress has decided that areas should receive all of the protections conferred on these Federal properties—permits and things like that—but the areas haven't actually been acquired by the government so the protections aren't there yet.

Senator WALLOP. I guess I don't track that logic.

Mr. BROWN. I guess the notion is that here we are in the face of Gramm-Rudman with few dollars to spend on buying a national wildlife refuge which the Congress has designated we should buy—Congress having determined that the area is sensitive and important, and should receive all the protection of the National Wildlife Refuge Management Act—but the area has not yet been acquired and doesn't have that protection. It is that area that would be free of tax subsidies pending acquisition.

Senator WALLOP. But I still don't track the logic. can you not do it in the other, by the fact that it has already been designated? We have demonstrated the capabilities. It seems to me that when you have the capability, and all that is necessary is to require it, it is best not to do strange things to the Tax Code and create yet another classification.

Ms. **Babcock**. If I can add to Mr. Brown's comment. Because some of these laws that provide for designation of these lands, you know, places them into a certain protective Federal system, would be defeated if development activity were to go forward on these lands.

Senator **Wallop**. But you can do that other than through the Tax Code, and it is already done other than through the Tax Code.

Ms. **Babcock**. Under some of the laws, but not under others. We have a perfect example right now involving critical habitat for the five remaining California condors. Congress last year appropriated money specifically for acquisition of condor habitat. The Department of the Interior has recently broken off negotiations with an owner of a critical part of that habitat. In fact, the Fish and Wildlife Service was engaged in condor trapping activities on that property. The owner of the habitat, in response, has asked the Fish and Wildlife Service to withdraw from his property because the owner wants to develop it. Now, clearly, it is in the owner's economic interest, in part due to the Tax Code, to develop his property although, up until this recent decision by Interior, he was indeed a willing seller to the Government.

So, this legislation allows the status quo to remain until acquisition or designation activities can occur, and does not allow the balance to tip artificially in favor of development.

Mr. **Brown**. But it doesn't control any private activities. It simply removes the tax subsidies that would encourage development.

Senator **Chafee**. All right, fine. Thank you all very much for coming. We appreciate it, each of you, for taking the time.

Our final panel will consist of Mr. Penn and Mr. Stahl. If you would each come forward, we would appreciate it; if those who are leaving would do so quietly. Mr. Penn, why don't you proceed?

Senator **Wallop**. Mr. Chairman, could I just have a minute to introduce Mr. Penn?

Senator **Chafee**. Yes, please do.

Senator **Wallop**. Mr. Penn is from Casper, WY. He is an employee of the American Oil Co., but he is an employee with a rare set of qualifications which enables him to testify on this subject. His job really is to make that company environmentally sensitive, and he has been remarkably successful in that. He also, as you know, is representing here the Rocky Mountain Gas and Oil Association. I just wanted to be over here and welcome him because I think his testimony, considering his qualifications, is something that we ought to bear very much in mind.

Senator **Chafee**. Thank you, and we join Senator Wallop in welcoming you, Mr. Penn and if you would proceed.

STATEMENT OF BRADLEY G. PENN, LAND/ENVIRONMENTAL COORDINATOR, MARATHON OIL CO., CASPER, WY ON BEHALF OF THE AMERICAN PETROLEUM INSTITUTE, ROCKY MOUNTAIN OIL AND GAS ASSOCIATION, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA, ALASKA OIL AND GAS ASSOCIATION, INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS, AND WESTERN OIL AND GAS ASSOCIATION

Mr. PENN. Thank you, Mr. Chairman and Senator Wallop. My name is Bradley G. Penn, and I am here today to testify for the American Petroleum Institute, the Rocky Mountain Oil and Gas Association, the Independent Petroleum Association of America, the Alaska Gas and Oil Association, the International Association of Drilling Contractors, and the Western Oil and Gas Association; and I request that the written testimony be made part of the record.

Senator CHAFEE. It will be.

Mr. PENN. Our associations represent individuals, independents, and companies who are of varying sizes involved in every aspect of the petroleum industry. As Mr. Wallop said, I am employed by Marathon Oil Co. in Casper, WY; and I have been a resident of Wyoming for nearly 10 years.

My background includes a degree in biology, and I have worked as an environmental specialist for nearly the last 9 years in air quality, vegetation, wild life, and permitting aspects. As you can see from my background, I am not here as a tax expert; rather, I am here to present information on the implications of this legislation as it relates to environmental zones. I have with me Karl Moody from the IPAA and Andrew Yood from ApI to handle any specific tax questions that may arise or to the tax aspects of this bill. However, this is in essence a land-use bill and the wide-reaching impacts its provisions would have on current multiple-use lands and the environmental protection afforded these lands are significant. The disincentives this bill provides or creates are an attempt to prohibit mineral development by increasing the burden of risk of mineral development substantially. Oil and gas exploration, by its very nature, is a high-risk business.

The tax benefits accorded under the current Tax Code provisions help spread the risk at economical levels. The closure of additional lands to energy develo.oment through this legislation would occur at a time when the United States is importing neerly 30 percent of its energy and oil from overseas. The ready and growing access to foreign oil has led many people to become complacent about the U.S. energy situation. Little recognition is given to the fact that today's oil surplus exists not because of overdomestic production but rather because there is a surplus in the oil world market.

Wyoming is a State highly dependent on mineral extraction and specifically oil and gas activity. With the current downturn in prices, the lack of access to many areas with high oil and gas potential, and the current budget cuts, the State's economy is feeling the pinch. Any further restrictions on incentives or access will only lead to larger problems for Wyoming and the United States.

This bill has specific language to eliminate oil and gas activity in environmental zones, even though the industry has shown through numerous examples that their operations can be compatible with wildlife and sensitive environments. One example that comes to mind is the Aransas Pass operation on the coast of Texas in the Aransas National Wildlife Refuge; and the February 1981 issue of National Geographic had an article called "Oil and Wildlife Mix." The article explains the oil and gas operations that preceded the designation of this wildlife refuge which has 10 currently or previously listed threatened or endangered species in the oil and gas operation areas. It outlines some of the mitigative and safeguard measures used to protect and ensure the safety of these animals. There are other examples. Senator Wallop mentioned Avery Island in Louisiana, a bird sanctuary; the Rockefeller State Wildlife and Game Reserve not far from Avery Island; the National Audubon Society Rainy Wildlife Refuge in southern Louisiana.

The API figures on environmental expenditures show that from 1974 through 1983, $31 billion was spent by the industry on protection of environmental resources.

One other pertinent point is the potential land exchange between the BLM and the Forest Service which would bring 25 million acres of Federal land under the jurisdiction of new Forest Service regulations and invoking the Tax Code to those lands is provided in S. 1839. We believe, in closing, that the Tax Code should not be used as a land withdrawal mechanism. The use of S. 1839 as a land use-planning tool for environmental purposes is inappropriate. We oppose this legislation, Mr. Chairman, and urge the subcommittee not to further hamper domestic oil and gas exploration and production. Thank you.

Senator CHAFEE. Thank you very much, Mr. Penn; and now, we will hear from Mr. Stahl.

[The prepared statement of Mr. Penn follows:]

TESTIMONY OF

BRADLEY G. PENN

on behalf of

AMERICAN PETROLEUM INSTITUTE
ROCKY MOUNTAIN OIL AND GAS ASSOCIATION
INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
ALASKA OIL AND GAS ASSOCIATION
INTERNATIONAL ASSOCIATION OF DRILLING CONTRACTORS
WESTERN OIL AND GAS ASSOCIATION

Presented to the

Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate

on

S. 1839

January 31, 1986

Mr. Chairman and members of the Subcommittee. I am Bradley G. Penn with Marathon Oil Company in Casper, Wyoming. I am representing the American Petroleum Institute (API), the Rocky Mountain Oil and Gas Association (RMOGA), the Independent Petroleum Association of America (IPAA), the Alaska Oil and Gas Association (AOGA) and the International Association of Drilling Contractors (IADC) and the Western Oil and Gas Association (WOGA). These associations represent companies of all sizes as well as individual members involved in all phases of the petroleum industry. We appreciate the opportunity to present comments on S.1839 and to emphasize the importance of finding and developing our country's oil and natural gas reserves.

S.1839 would amend the Internal Revenue Code to disallow certain deductions and credits for expenditures within "environmental zones." The intent of the legislation is to stop mining and oil and gas operations in those "environmental zones" which are defined as areas of critical habitat under the Endangered Species Act; lands authorized by Congress or designated by the Secretary of Agriculture or Interior for inclusion within the National Wildlife Refuge System, National Park System or National Forest System, but not as yet part of such systems; areas which are units of the Coastal Barrier Resources System; natural national landmarks; and land authorized by Congress for study as a potential unit of the Wild and Scenic Rivers System.

The effect of S.1839 would be to make exploration for and production of oil and gas economically less attractive in "environmental zones" by slowing the rate of capital cost recovery and eliminating certain tax credits. This negatively affects the cash flow and internal rate of return of any potential project in an "environmental zone". Thus, fewer such projects will be undertaken at a time when the United States should be encouraging, rather than discouraging, domestic production of oil and gas.

The ready and growing access to foreign oil has led many people to be complacent about the nation's energy situation. Little recognition is given to the fact that today's oil surplus exists not because the U.S. is self-sufficient in energy, but rather because there is a surplus of oil on the world market. But surpluses can change to shortages -- as in 1973 and 1979.

During those periods of shortages, pessimistic energy forecasts indicated that Americans would face even tighter energy supplies and would become even more dependent on foreign oil. Behind such predictions was the belief that prices had little impact on supply and demand. But price did affect both supply and demand throughout the world. With higher prices, more energy was discovered in this country.

Predicted shortages gave way to ample supplies in the early 1980's, and pessimism gave way to complacency.

That complacency continues today. It is obscuring a number of troubling long-term energy indications, including the following:

- The number of crews actively engaged in seismic exploration dropped by 27.5 percent between 1981 and 1984 (from an average of 681 crews to an average of 494 crews). The decline continued through 1985, with the number of crews active in December 1985 down 323, the lowest rate since mid-1977.

- The number of rotary rigs actually drilling declined by 40 percent between December 1981 and December 1984 (from an average of 4,520 rigs to an average of 2,713 rigs). By the end of December 1985, the average number of rigs working had dropped to 1,898, a 30 percent decline from the December 1984 average.

- Exploratory drilling for oil and natural gas declined 30 percent in 1984 from its peak in 1981, and the number of successful wells dropped by 42 percent over the same period -- foreshadowing future declines in gas and oil reserves.

- From 1971 through 1984, the U.S. produced almost 45 billion barrels of oil, while finding only 34 billion barrels, and produced 274 trillion cubic feet of natural gas (48.8 billion BOE), while finding only 181 trillion cubic feet (32.2 billion BOE). Since 1970, the nation's proved reserves have declined 30 percent from 39 billion barrels of oil and 290.7 trillion cubic feet of natural gas (51.7 billion BOE) at the start of 1971 to 28.4 billion barrels of oil and 197 trillion cubic feet of natural gas (35.1 billion BOE) at the beginning of 1985.

o Meanwhile, after years of decline, U.S. oil consumption rose more than 3 percent in 1984. This was the first year-to-year rise since 1978 and was in large part the result of lower prices and the improved economy. Consumption was essentially unchanged in 1985 overall, but appeared to be increasing again the last half.

It is important that this nation find and produce more petroleum energy in the United States to ensure its future energy security. But that won't happen if more and more lands are effectively put off limits to oil and gas activities.

The nation's policymakers must deal with these problems -- declining U.S. exploration, drilling and reserves and increasing U.S. consumption -- or America's dependence on foreign oil could increase sharply. The day of tight supplies could be hastened if the dollar declines relative to foreign currencies. That could mean both lower oil prices and higher consumption abroad. The result would be a quicker reduction in the world's excess oil-producing capacity. That would once again allow Persian Gulf countries to dominate events through slight increases or decreases in their oil exports.

Many of this country's oil and gas fields have been operating for decades and are rapidly being depleted. Even in the giant Prudhoe Bay field on Alaska's North Slope, more than one-third of the recoverable oil already has been produced, and there is no transportation system available to deliver the huge amounts of natural gas found there.

The nation's oil reserves must be maintained if the United States is to avoid future declines in domestic production, heavier dependence on foreign oil and increased vulnerability to the economic shocks and security threats that are usually associated with disruptions in international oil shipments.

U.S. proved petroleum reserves have declined by about 30 percent since 1970. Discoveries have lagged far behind production in many of those years. Just to maintain current levels of reserves and domestic production, the United States needs to find the equivalent of about 9 million barrels of oil and 50 billion cubic feet of natural gas every day. This country needs to find 180 percent of today's proved reserves by the year 2000. But it is becoming increasingly difficult to find that much oil and gas. Exploratory drilling completions have dropped almost 30 percent below their 1981 peak level.

Given current and projected estimates of U.S. consumption and production of petroleum, it is important that energy policymakers look far ahead and formulate policies that ensure that the U.S. makes efficient use of its resource base so as to minimize its vulnerability to future energy supply disruptions.

Above all, energy policy planners need to recognize that change is inherent in world energy markets. Energy cycles are driven by supply, demand and price. Public policy, wisely shaped, can make these cycles less extreme and avert supply crises.

But, policy planners cannot put off taking action until the next cycle occurs. That's because it takes years to find and develop new supplies of oil and natural gas. It also takes years to modify or develop energy-using equipment for consumers and businesses either to shift from one fuel to another or to use a given fuel more efficiently. In short, the nation cannot wait for a crisis to occur before acting to assure adequate future supplies.

What is needed now are sound energy policies that encourage oil companies to explore for and find the oil and natural gas this nation will need in the 1990s and beyond. S.1839 would have the opposite impact. It would discourage needed exploration and production.

It is important to begin today the search for and development of tomorrow's oil and gas supplies because:

- it often takes several years to evaluate prospective onshore lands -- if they are available -- before the decision is made to acquire the lease; and,

- it frequently takes from 8 to 11 years, once the leases are acquired, to begin production after a discovery is made.

Currently, U.S. oil companies are not allowed to look for oil and gas on more than 300 million acres of federal lands that have been placed off limits to energy exploration. In addition, millions of acres of federal onshore lands -- while "open" to oil and gas operations under existing laws -- are effectively closed by lease stipulations which severely restrict such operations.

Tens of millions of acres of other federal lands have been withdrawn or are subject to possible withdrawal from oil and gas operations under other laws. These lands include those affected by the Alaska Native Claims Settlement Act, the Endangered Species Act, the Clean Air Act, the Federal Land Policy and Management Act and proposals to establish "buffer zones" around national parks. Here, too, the petroleum industry is concerned over the trend to withdraw these lands from, or to restrict, oil and gas activities without adequate consideration of their petroleum and other mineral potential.

In the western states, federal, state and private lands are intermingled in a checkerboard pattern. In addition, a lease block may include a combination of federal, state and private lands. Actions taken by the federal government on its lands have a direct effect on the surrounding state and private lands.

S. 1839 specifically refers to several classifications of federal land systems and a brief differentiation of types of lands is important to clarify our concerns.

While both the Forest Service and Bureau of Land Management have mandates to manage their lands for multiple-use purposes, not all of those lands are available for mineral activities. For example, the National Park, the National Wilderness Preservation, and the National Wildlife Refuge Systems, have special laws governing activities within their boundaries. Mineral leasing is prohibited by law within the National Park System and the National Wilderness Preservation System, and is only allowable in some areas and under certain conditions within the National Wildlife Refuge System. The industry's objection to S.1839 legislation does not represent a desire to open these areas up to development.

However, lands to be included in the National Forest System that are available for management under the principles of multiple use would be affected by this legislation. An elaborate process exists by which the Forest Service and Bureau of Land Management plan the activities on those multiple use lands. State agencies, federal agencies, private organizations and private individuals participate in the planning process.

The impact of alternative uses is estimated to determine possible adverse effects, the relationships between short-term uses of the environment and long-term maintenance or enhancement of the environment's productivity, and ways to lessen any adverse effects. For example, when an oil and gas lease is issued, stipulations or conditions may be attached to that lease to disallow certain actions or to limit the time when operations can take place so as to protect the wildlife. Thus, the present and traditional public land law provides an efficient means to manage both the government lands base and its resources. The passage of S.1839 is not needed as an additional device to protect environmentally sensitive areas.

Mineral revenues generated from onshore federal lands are substantial. In 1984, the total revenue from oil and gas activities on onshore federal lands was $1,184,518,877 of which $542,646,214 was returned to twenty-eight states; $414,868,042 was included in the Reclamation Fund; $76,589,697 was collected from Windfall Profit Taxes; and $150,414,924 was returned to the general U.S. Treasury.

The principal reason for most land withdrawals is concern for the environment. Responsible environmental concern is understandable and is shared by the petroleum industry. But an objective examination of modern petroleum activities demonstrates that energy production and environmental protection are compatible. Millions of barrels of oil are being produced safely in the United States every day in sensitive environments -- including wildlife refuges in the Gulf of Mexico and Alaska and the fragile tundra of the North Slope of Alaska.

In addition, dozens of environmental protection laws that affect energy development on federal, state and private lands are on the books and have been for years. Stiff penalties apply -- as they should -- if environmental rules are not followed. Protection of the nation's environment is essential.

The petroleum industry supports the basic goals of environmental laws and regulations. However, it believes the implementation of environmental laws and regulations needs to be continually reevaluated and adjusted to avoid unnecessarily stifling petroleum development.

S.1839 would add a layer of tax compliance concerns to the administration of the environmental laws. The Internal Revenue Service and the Treasury Department are already overburdened with complicated regulations projects spawned during the flood of tax legislation over the past few years. Both taxpayers and the Internal Revenue Service would be faced with a new series of complex rules that may add little to the protection of the environment, but could cause a significant shift in the use of the Service's limited resources away from its primary function of assuring uniform compliance with the tax laws.

With respect to energy, too often government decision-making in recent years has presented environmental protection and energy production as either/or alternatives. Too little recognition has been given to the progress that has been made in improving the quality of the nation's air, water and land. This attitude is especially prevalent with respect to onshore federal lands.

Historically, many of these federal lands were intended to be used in many different ways -- including energy and mineral development. Laws adopted by Congress, beginning in 1872, have said that natural resources on government lands should be developed in an orderly and timely manner to meet the needs of all Americans. Indeed, some lands now in the Wilderness System were used for various purposes, including oil and gas activities, before they became part of the wilderness system.

An example is the Palisades area of the western overthrust belt. An oil company leased a site shortly before the U.S. Forest Service recommended it for inclusion in the Wilderness

System. After drilling, the company worked with Forest Service experts to reclaim the site. Today, the only indication that any drilling activity occurred there is the grass which covers the site.

In the Palisades area and elsewhere, petroleum exploration and production have been shown to be only temporary intrusions and to have no long-term adverse impact on the "wilderness" value of the land. Moreover, the acreage involved in drilling any exploratory well is small - normally five acres or less. And that acreage will be used only if seismic and other data indicate that drilling a well is warranted.

Even when drilling proves successful -- and on average only about 15 percent of new-field wildcat wells drilled in the United States find commercially producible amounts of oil or gas -- petroleum operations are conducted only for as long as the field remains productive. Within 20 to 30 years, most fields are depleted of their recoverable oil and gas. The land is then reclaimed. In the meantime, Americans will have benefitted from the availability of that secure, domestically produced petroleum.

The effect of S.1839 would be to make exploration for and production of oil and gas economically less attractive in certain areas defined as environmental zones. We believe that the tax code should not be used as a land withdrawal mechanism. The use of S.1839 as a land use planning tool for environmental purposes is inappropriate.

It is clear that the intent of S.1839 is to prohibit mineral exploration and development within areas designated, or yet to be designated as "environmental zones." By attempting to burden high risk mineral activities with substantially reduced ability to recover development capital, this legislation in effect withdraws from mineral activity any lands falling into the classification of "environmental zones."

Further, the depletion provisions in the bill would especially disadvantage independent operators. While major companies are not permitted a percentage depletion under existing law, independent operators are allowed such deductions. The depletion provision of S.1839 would tend to discourage independents, who make substantial new hydrocarbon discoveries each year, from exploring promising areas that might be designated as environmental zones.

In conclusion, Mr. Chairman and members of the Subcommittee, we oppose the enactment of S. 1839. Thank you for the opportunity to present our comments.

STATEMENT OF DAVID E. STAHL, PRESIDENT, NATIONAL FOREST PRODUCTS ASSOCIATION, WASHINGTON, DC, ACCOMPANIED BY WILLIAM CONDRELL, GENERAL COUNSEL, FOREST INDUSTRY'S COMMITTEE ON TIMBER VALUATION AND TAXATION; AND MARK REY, VICE PRESIDENT, PUBLIC FORESTRY PROGRAMS, NATIONAL FOREST PRODUCTS ASSOCIATION

Mr. STAHL. Good afternoon. I would like to thank Chairman Chafee and the members of the subcommittee for allowing me to testify on S. 1839. My name is Dave Stahl. I am president of the National Forest Products Association. With me are Bill Condrell, general counsel of the Forest Industry's Committee on Timber Valuation and Taxation, and Mark Rey, vice president of Public Timber of the National Forest Products Association.

NFPA is a national trade association representing over 2,000-member companies that own and manage forest lands and manufacture solid wood products. A number of NFPA's member companies are dependent on fiber from lands managed by the U.S. Forest Service. I am also offering this statement on behalf of the Southern Forest Products Association, whose members in the 12 southern States account for over 55 percent of the Nation's southern pine lumber production.

NFPA, SFPA, and their member companies strongly favor retaining provisions of the current law regarding capital gains treatment for timber. We have testified on this subject on July 10, 1985 before the full committee. I am submitting a copy of that testimony for the record. In that testimony, we discussed the merits of capital gains treatment for timber as part of a wise and forward-thinking tax policy. S. 1839 would selectively eliminate capital gains treatment for timber as an environmental rather than revenue generating initiative. Today, therefore, I will focus on whether abolition of capital gains in such areas is wise environmental policy. In this respect, we believe the basic premise underlying the bill is flawed, that is, S. 1839 does not set forth policy objectives that are consistent with the objectives of the Nation's environmental policies.

It provides a very poor forum of coordination between the Tax Code and environmental and natural resource statutes. Rather than evaluating the impact of a given activity on the environment, as is provided for in virtually all of the environmental and natural resource statutes written by the Environment and Public Works, Energy and Natural Resources, and Agriculture Committees, S. 1839 starts with the assumption that certain activities are "unwanted and harmful" in certain areas. The bill does not provide a means of making judgments or evaluations as to why they are unwanted, how harmful they are, what their cost to society is, or whether existing environmental programs are adequate to control the activities in question. For instance, S. 1839 assumes, without offering evidence, that timber harvesting is always bad in areas identified as environmental zones. I have provided other examples in my written statement for the record. The industry also has a number of concerns with the way the bill is drafted. For instance, section 2(d)(1) would prohibit the realization of any of the tax deductions or incentives eliminated by the bill in areas designated by the Secretary of the Interior as critical habitat for threatened or endangered species under the Endangered Species Act. This prescription, in effect, preempts the ESA's requirement for consultation between Federal agencies and the U.S. Fish and Wildlife Service.

The ESA does not presumptively hold that all activities of a critical area of a habitat must be stopped but allows consultation to determine what forms of restriction, if any, are needed. Section 2(d)(2), which defines environmental zones, is unclear. It could be read to include both the National Forest System and to private lands not yet acquired in the system but authorized for acquisition. We understand that only the latter is intended for inclusion in the environmental zone concept. In either case, the bill implies that timber harvesting is not an appropriate activity on national forest lands and therefore should be discouraged.

The impacts are significant, even if the bill is meant to include only those areas which have not yet been included forest system. The legislation will affect private land management on over 39 million acres of land, for which the forest service presently has some acquisition authority, even though the agency's acquisition priorities vary significantly for each piece of land. It is unclear why the present owners of these 39 million acres should be discriminated against through the Internal Revenue Code.

In conclusion, we do not believe this legislation represents the approach to environmental protection that has been the hallmark of your efforts, Mr. Chairman, on the Environment and Public Works Committee through the passage of legislation such as the 1977 Clean Air Act, and the current amendments to the Clean Water Act and Drinking Water Act upon which you are presently deliberating.

I will be pleased to respond to any of your questions.

Senator CHAFEE. Thank you very much, and I especially want to welcome Mr. Condrell here. We were classmates in law school 36 years ago.

[The prepared statement of Mr. Stahl follows:]

STATEMENT FOR THE RECORD

OF

DAVID E. STAHL
PRESIDENT
NATIONAL FOREST PRODUCTS ASSOCIATION
1619 MASSACHUSETTS AVENUE, N.W.
WASHINGTON, D.C. 20036

ON S. 1839

BEFORE THE
TAXATION AND DEBT MANAGEMENT SUBCOMMITTEE
COMMITTEE ON FINANCE

OF THE
UNITED STATES SENATE

JANUARY 31, 1986

Good morning. I would like to thank Chairman Chafee and the members of the Subcommittee for allowing me to testify this morning with respect to S. 1839, a bill to amend the Internal Revenue Code to provide that certain deductions and credits not be allowed for expenditures within an environmental zone. My name is David Stahl. I am President of the National Forest Products Association (NFPA).

NFPA is a national trade association representing over two thousand member companies that own and manage forest lands, and manufacture solid wood products. In addition, a number of NFPA's member companies are partially or wholly dependent on fiber from lands managed by the U.S. Forest Service. I am also offering this statement on behalf of the Southern Forest Products Association, whose members in twelve southern states account for over 55% of the nation's southern pine lumber.

NFPA, SFPA, and their member companies strongly favor retaining provisions of current law regarding capital gains treatment for timber. We testified on this subject on July 10, 1985, as the full Committee considered other revisions to the Tax Code. I have submitted a copy of that testimony for the record. In that testimony, we discussed the merits of capital gains treatment for timber as a part of a wise and forward-thinking tax policy. S. 1839 would eliminate capital gains treatment for timber in selected areas, called environmental zones. It would do so as an environmental, rather than revenue generating, initiative. Today, therefore, we will focus on whether abolition of capital gains in such areas is wise environmental policy.

In this respect, we believe that the basic premise underlying this bill is flawed. That is, S. 1839 does not set forth tax policy objectives that are consistent with the objectives of our environmental policies. We believe that it provides a very poor form of coordination between the Tax Code and environmental and natural resource statutes.

Virtually all of the environmental and natural resource statutes written by the Environment and Public Works, the Agriculture, or the Energy and Natural Resources Committees start from the proposition that an activity should be evaluated in light of its impact on the environment, and a decision should be made as to whether that impact is beneficial, neutral, or detrimental. If a detrimental impact is identified, then the statutes drafted by these three committees provide means of addressing the impact through regulatory mechanisms or prohibitions. Generally, federal or state agencies are charged with the responsibility to perform the required evaluations and implement any necessary controls.

S. 1839, however, starts with an assumption that certain activities are, *ipso facto*, "unwanted and harmful" in particular areas. The bill does not provide a means of making judgments or evaluations as to why they are unwanted, how harmful they are, or whether existing environmental programs are adequate to control the activities in question. For instance, S. 1839 assumes, without evidence, that timber harvesting is always bad in the areas identified as environmental zones. This assumption of prospective harm is inconsistent with the present practice of first evaluating the degree of impact of a particular activity, and then creating a means of control that addresses that impact in as specific a fashion as possible.

Take for example, the reference in your introductory remarks to the Office of Technology Assessment March 1984 report -- *Wetlands, Their Use and Regulation*. One of the findings of this study was, as you quoted, that "tax deductions and credits for all types of general development activities provide the most significant Federal incentive for farmers to clear and drain wetlands." We are familiar with this Office of Technology Study because we served on the Advisory Committee to the OTA staff in charge of preparing the report.

During the course of this study, the OTA staff reviewed a substantial amount of data that suggested that, insofar as agricultural land clearing is concerned, Federal tax deductions and credits provide an incentive for the clearing of valuable wetland areas for agricultural production. The study also included an assessment of the environmental impacts associated with such activities. In this specific instance, there is a data base which suggests that the Tax Code could be modified to deal with a particular activity which has been deemed to have some negative environmental impacts.

S. 1839 does not include wetlands, as defined under the 1977 Clean Water Act for example, as environmental zones. Thus, rather than building upon existing information such as the OTA study, which is limited in scope to an instance where it has been demonstrated that the Tax Code is at issue, the bill starts forward with the presumption that certain activities are always bad.

S. 1839 would initiate an economic disincentive to harvest timber. I hope that this Committee is not prepared to embark upon a campaign of utilizing the Tax Code to curtail certain practices -- particularly when the potential harm of those practices has not been verified.

We also have a number of other concerns with the way that the legislation is drafted. For example, Section 2(d)(1) would prohibit the realization of any of the tax deductions or incentives covered by the bill in areas designated by the Secretary of the Interior as critical habitat for a threatened or endangered species under the Endangered Species Act (ESA).

This proscription, in effect, preempts the ESA's requirements for consultation between Federal agencies and the U.S. Fish and Wildlife Service. For all other Federal activities that would be likely to jeopardize the continued existence or adversely modify the critical habitat of an endangered species, Section 7 of the Endangered Species Act requires consultation between the Federal agency involved and the Fish and Wildlife Service. The purpose of this consultation is to determine what forms of restrictions are necessary for the activity in question so that the critical habitat is not damaged. The ESA does not presumptively hold that all activities in an area of critical habitat must be stopped.

Moreover, there are instances where the recovery plans for threatened and endangered species involve cooperative activities by both public and private landowners in areas of critical habitat. For example, some of our members are involved in recovery team efforts, and coordinate their land management activities with those of adjacent Federal land managing agencies. S. 1839 would deny our members in this situation capital gains treatment of timber without recognizing this record of cooperation with the Fish and Wildlife Service in recovery efforts.

Section 2(d)(2), which defines "environmental zones," is unclear. It could be read to include both: (1) the national forest system; and (2) private lands not yet included in the system, but authorized for acquisition. We understand that only the latter is intended for inclusion in the environmental zone concept.

In either case, the bill assumes that timber harvesting is not an appropriate activity on national forest lands, and should therefore be discouraged. The bill does not take into account the Multiple Use Sustained Yield Act of 1960, the Resources Planning Act of 1974, and the National Forest Management Act of 1977 -- statutes which have been carefully crafted by the Agriculture and Energy and Natural Resource Committees to assure balanced forest management on the national forests.

The impacts are significant even if the bill is meant to include only those areas which have not yet been included within, but are authorized to be a part of, the national forest system. The legislation will affect private land management on over 39 million acres of land, for which the Forest Service presently has some acquisition authority even though the Agency's acquisition priorities vary significantly for each piece of land.

For example, denying tax deductions, credits, or reduced rates will be a particular problem in the East, where 23 purchase units that have not been made national forests still exist. These units were created primarily in the 1930's at the same time that many of the eastern national forests were established. They involve almost 2 million acres of land that the government has not and likely will not acquire in the near future due to financial limitations, or a reassessment of the need for these holdings to be part of the national forest system. In some cases, marginal farm lands in these areas are already being managed for forestry purposes so there is no longer a pressing need to make them part of the National Forest System to achieve this end.

It is unclear why the present owners should be discriminated against through the Internal Revenue Code. In many cases, the owners of these lands are already coordinating the management of their holdings with the Forest Service so that access and land management activities are done in a fashion which is consistent with the Forest Service plans for the adjacent or interlocking federal lands. S. 1839 would create an anomalous situation in which a logger harvesting federal timber would receive capital gains treatment, while his counterpart on either nearby private lands, or in a purchase unit would not.

Section 2(d)(5) ignores the specific provisions of Section 7(b) of the Wild and Scenic Rivers Act. Section 7(b) prohibits federal grants, loans, licenses or other assistance for the development of water resources projects in areas authorized for study as units of the National Wild and Scenic Rivers System. Historically, federal agencies have interpreted this restriction broadly to include any projects which interfere with the free-flowing nature of the candidate river.

Inasmuch as the Federal government has asserted this broad regulatory control over areas authorized for study, it is unclear why this legislation is needed. Moreover, the legislation could have the counterproductive result of encouraging landowners to escalate timber harvesting plans in some areas upon introduction of a bill that demonstrates that Congress is considering a particular river for study status.

In conclusion, we do not believe that this legislation represents the approach to environmental protection that have become the hallmark of your efforts, Mr. Chairman, on the Environment and Public Works Committee, such as the 1977 Clean Water Act, the 1977 Clean Air Act, and the current amendments to the Clean Water Act and Drinking Water Act upon which you are presently deliberating.

We would be pleased to respond to any questions.

(150)

Senator CHAFEE. Now, I think there is one point I would stress, both in answer to both your testimony, Mr. Stahl, and to that of Mr. Penn, the point is that this legislation does not prohibit anything. Now, you can say in effect it prohibits it because we deny special tax treatments for development; but here is the situation.

If we advance on the assumption that these tax incentives were put into the code for certain reasons, namely to encourage the timber industry or to encourage any development, as it were, isn't there a conflict between that encouragement by the Federal Government on one hand, and on the other hand, the Federal Government saying these lands are designated for future acquisition by the park department. We haven't got the money to get them yet, but we are planning to get them; and therefore, it doesn't seem to make a great deal of sense for the Federal Government to be giving a subsidy—if that is what a tax incentive is—to the company to develop this land when, on the other hand, we are planning to take the land in *X* years or as soon as we can. What do you say to that, Mr. Penn?

Mr. PENN. I would like to use a few analogies. One would be that, when you take away the tax incentives, you are probably taking away incentives for that extra step in environmental protection. And the example I would like to give you is the well that Marathon drilled outside of Cody, WY, called the North Fork Well, where we used helicopter mobilization. There was no critical habitat designated, but as you know, under the Endangered Species Act, a consultation is required with the U.S. Fish and Wildlife Service to determine the impacts, in this case of a class 3 species of plant and the grizzly bear because of use in the area. With helicopter mobilization, the impacts were further limited than through the standard use of a road, which still had minor or slight impacts. About the only impact that was outlined in the environmental impact statement was the noise from helicopter use, but that was determined that, since it was a constant flight corridor, the animals would habituate to that.

Another example, as far as designation of future areas, is Glacier National Park where there have been two or three wells drilled in what are now the park boundaries, and the initial road going into the park on the west side was a road to drill an oil well. The other is in Mary Bay, I believe, covered up by the lake now. So, it hasn't affected the designation of existing areas.

Another example would be the Gros Ventre Wilderness Area, WY, although wilderness areas are not specifically addressed in this bill. It is an example to show that oil and gas activities have occurred in wilderness areas and have not precluded their designation as wilderness areas. The example are two wells on Toss Eye Creek in the Gros Ventre Wilderness Area of Wyoming. The easiest access there is from Pinedale going north toward Green River Lakes.

Senator CHAFEE. Mr. Stahl.

Mr. STAHL. I think, Senator, our problem is that we are unwilling to admit that timber harvesting per se is harmful, and we don't think the bill proves that and shows that. There are within the law already ways of protecting wilderness or wildlife habitats. Many of the things that the bill is aimed at don't involve removing the incentives that exist broadly within the society that were placed there in order to encourage the private sector to plant trees and to reforest to assure that we would have a continuing fiber supply. I think there are ways to deal with the problem without broadly denying those incentives that have been so necessary and have been so successful since they were first adopted in 1944.

Senator CHAFEE. Just in passing, Mr. Penn, in your statement you say: "Oil companies are not allowed currently to look for oil and gas in more than 300 million acres of Federal lands." What would the largest portion of those lands be?

Mr. PENN. The largest portion would be 89 million acres of wilderness that is currently designated; 43 million in additional national parklands, 13 million in national wildlife refuges, and Alaska Wildlife Refuges make up a large portion—well, actually, in addition to that, another 45 million acres.

Senator CHAFEE. Fine; thank you. Mr. Stahl.

Mr. STAHL. Senator, I would like to ask Bill Condrell to comment further on this.

Mr. CONDRELL. I just wanted to add one other point, Senator. David's answer was complete as to the new growth, but we do have a category of timber that is already standing. And that needs care. Now, as I understand these areas that are not yet in the system, the Federal Government does not have the resources to take care of them, in terms of fire control particularly, or disease, and similar cultural activity. The capital gains treatment, therefore, provides or has provided, at least traditionally, the major incentive for private owners to do the cultural activity needed to be done to maintain the trees in a healthy state. So, if you took that away from those lands in advance of the Government being able to do the investment on the lands, you run the risk of the timber simply more or less degenerating.

Senator CHAFEE. Thank you. Senator Wallop, do you have any questions?

Senator WALLOP. Mr. Chairman, I just have an item I would like to add. This legislation runs very counter to something that you have helped me on, and that is this whole area of conservation easement, where you try and provide tax incentives for people to donate the very kinds of protections which you seek here. By adding this to that, we may get some more conservation easements, but there is really no reason for the Government whatever to accept them because you can execute a taking. In effect what this amounts to is a taking by simply denying any economic ability to exploit the resources which, in this case, would be privately owned. So, I think that they don't work well together; and I think they are in opposition to each other's purposes.

Senator CHAFEE. Those are very good points, and I want to thank you all for coming. I appreciate it. It was very thoughtful testimony. That concludes our day.

[The statement of the Public Securities Association follows:]

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION BEFORE THE SENATE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

The Public Securities Association welcomes this opportunity to express its support for the objectives of Senate Bill 1959, also known as the "Secondary Market Tax Amendments of 1986" (SECTA) and, Senate Bill 1978, also known as the "Recovery Act for Mortgage and Other Asset-Backed Securities" (RAMBO). These proposals would remove many of the statutory and regulatory impediments which have prevented the issuance of multiple-class mortgage pass-through securities. These impediments have inadvertently had the effect of preventing mortgage-backed securities from becoming a more efficient means of financing residential housing. Moreover, these pieces of legislation will foster the creation of a well-balanced mortgage credit distribution system and will promote the linkage between the nation's capital markets and its mortgage credit markets, to the benefit of all homebuyers throughout the country.

PSA is the national trade association which represents the commercial banks and securities dealers which underwrite, trade and distribute mortgage-backed securities, U.S. government and federal agency securities and state and municipal securities. Included among our membership of approximately 300 firms are all the leading mortgage-backed securities dealers and all thirty-six primary government securities dealers as recognized by the Federal Reserve Bank of New York.

The residential secondary mortgage market is of rather recent origin. The first secondary mortgage market transaction between two savings and loan institutions took place in 1949. This market is the principal means by which thrift institutions and other mortgage originators are able to sell newly originated mortgages, or older mortgages held in portfolio, to raise capital to finance new mortgage loans. This has been accomplished through the sale of either whole mortgages or through the use of mortgage-backed securities. Mortgage-backed securities have provided the advantages of greater liquidity and diminished risk of loss than the purchase of individual whole mortgages.

Historically, the function of this market was to redistribute funds among various areas of the nation which might have been facing regional mismatches in the cost and availability of mortgage credit. For example, many slower growing areas of the country faced periods of time where there was a greater supply of mortgage credit available for lending than demand for it by local homebuyers. Conversely, many of the faster growing areas of the country frequently had greater demand for mortgage credit than dollars available to lend. The secondary mortgage market by purchasing mortgages in the faster areas of growth and selling them in the slower growth regions, redistributed available mortgage funds throughout the country. This system proved to be adequate for many years.

However, today, additional sources of investment in residential mortgages are necessary because nationwide demand for mortgage credit has increased more rapidly than the deposit bases of traditional mortgage lending institutions. The proposals being considered by the Committee today represent efficient vehicles for accomplishing this vitally important public policy objective. Through the years the Congress has taken a leadership role in developing the residential secondary mortgage market. The Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC") have each been and should continue to be important elements in this market's projected growth. Collectively, these federally created organizations have been responsible for issuing approximately $370 billion in mortgage backed securities.

It has been estimated that the total mortgage credit need for 1986 could exceed $230 billion. In order to efficiently provide this staggering volume of mortgage credit, we urge the Congress to begin to take steps to promote more efficient means of securitization and sale of mortgage-backed securities. (For purposes of this statement, securitization means the process by which large numbers of mortgages are pooled into mortgage-backed securities which are subsequently sold in fractionalized form as security interests in the pooled mortgages.) Over the next decade it has been estimated that $4 trillion dollars will be needed to finance housing in this country. The only way to satisfy this enormous demand for mortgage credit is to encourage additional access to our nation's capital markets from the private sector. This can best be accomplished through the creation of new mechanisms which allow mortgage issuers to more efficiently securitize mortgages. The adoption of legislation like SECTA and RAMBO would represent a significant positive step in this direction.

We anticipate many benefits from these legislative initiatives. In our opinion, the most significant of these benefits will be the removal of uncertainty with regard to the tax implications of establishing a multi-class pool of mortgage-backed securities. At the present time, pools of mortgage-backed securities are typically organized in the form of "grantor trusts." Unless organized in this fashion, pools of mortgage-backed securities would be subject to taxation at both the pool-level and at the investor level. Both, the RAMBO and SECTA proposals contain provisions making it clear that income from these multiple-class mortgage-backed securities would only be recognized at the investor level. The RAMBO proposal allows multiple classes of pass-through securities to fall within the amended provisions of the grantor trust rules, if these classes representing interests in the same pool of assets are issued simultaneously, and are not changed after issuance. The SECTA proposal accomplishes this by authorizing the creation of a new mortgage-backed security - the Collateralized Mortgage Security (CMS) which permits CMO-like investment arrangements to be structured as ownership interests in a passive multiple class entity.

In addition, clarifying the tax status of these instruments will result in reduced transaction costs and therefore result in greater market efficiency. Legal fees, along with other transaction costs, would be reduced because tax opinions would no longer be necessary. This would reduce costs that are ultimately borne by investors.

Both proposals would also allow for the sale of assets accounting treatment for tax purposes. By selling mortgages instead of issuing debt backed by mortgages, institutions would not be required to carry the added debt on their balance sheets. Since the transaction is not recorded as debt on the balance sheet it will greately benefit lenders without large amounts of capital. This should significantly enlarge the universe of potential lenders and create additional sources of funds for the mortgage market generally.

Both RAMBO and SECTA also contain two major provisions which would tend to expand the "investor base" in mortgage-backed securities. First, both proposals provide that the instruments created would qualify as "investments in mortgages" under the Tax Code thus enabling thrift institutions and real estate investment trusts to invest in these securities. Second, both pieces of legislation permit the creation of different or multiple classes of securities based on the maturity and cash flow preferences of different types of investors. For example, this would permit the creation of mortgage securities that provide thrift institutions with the short maturities they need to match against their short-term liabilities; life insurance companies with the medium-term maturities they require; and pension funds with the stable long-term maturities which they prefer.

Moreover, it is reasonable to anticipate that the increased marketability of these types of securities will result in more advantageous pricing. Greater competition among mortgage lenders at the origination level, as well as greater competition among mortgage-backed securities dealers to serve as market makers in these securities should lead to this result. As the secondary mortgage market becomes even more liquid and efficient we also expect to witness a narrowing in the yield spreads between mortgage-backed securities and Treasury securities. Lower mortgage interest rates at the origination level should result, significantly benefiting all of the nation's potential homebuyers.

For these reasons, we strongly support the objectives of the SECTA and RAMBO proposals and believe that Congressional consideration of this issue is perfectly appropriate within the context of the broader debate currently under way on the issue of comprehensive tax reform.

[Whereupon, at 12:48 p.m., the hearing was adjourned.]

[By direction of the chairman, the following communications were made a part of the hearing record:]

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EXECUTIVE DIRECTOR
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Edward L. Yingling
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February 14, 1986

The Honorable John H. Chafee, Chairman
Subcommittee on Taxation and
Debt Management
Committee on Finance
567 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Chafee:

The American Bankers Association appreciates this opportunity to present its views on S. 1959 and S. 1978, which were subjects of a hearing held January 31, 1986, by the Committee on Finance Subcommittee on Taxation and Debt Management. The American Bankers Association is the national trade and professional association for America's Full Service Banks. The combined assets of our member banks represent approximately 95 percent of the industry's total assets. We ask that our comments here be made a part of the record of that hearing.

The American Bankers Association supports S. 1959 and S. 1978. Both bills would establish reasonable rules for the tax treatment of the issuer of multiple-class pass-through obligations and for the investor in such instruments. The current confusion over the proper tax treatment of these pass-through obligations has inhibited the development of the secondary market; resolution of the outstanding tax questions will enable the market to more effectively and efficiently serve the needs of both borrower and investor and should result in lower interest rates.

S. 1959 represents a comprehensive approach toward the tax treatment of collateralized mortgage securities (CMSs). It provides rules for the tax treatment of issuers of CMSs and investors in CMSs, during the time the instruments are held and at disposition. It would provide detailed rules concerning the application of the original issue discount rules (OID) to such instruments. All of these rules are badly needed in order for the secondary credit markets to function at their optimum.

S. 1978 uses a different approach than does S. 1959. Introduced by Senator Cranston, S. 1978 would amend certain trust provisions of the Internal Revenue Code to permit multiple-class pass-through securities to qualify for treatment under the grantor trust rules. Currently, regulations under IRC Section 7701(a)(3) contain definitions of fixed investment trusts which bar the issuance of multiple-class pass-through securities by grantor trusts. By effectively overriding these regulations, S. 1978 would open up the secondary market to new investors.

S. 1978 does not contain the detailed OID rules found in S. 1959, but it does expand the CMS concept beyond the mortgage pass-through securities provided for in Senator Chafee's bill. It would allow CMSs to be issued for most types of debt instruments, including account receivables, lease receivables and auto loans. The ABA supports this expansion of the CMS concept into these new areas. We believe that the benefits to be obtained for the mortgage borrower by permitting multiple-class pass-through obligations should also be available for users of other types of credit. The ability to reduce risks and increase liquidity, and the resulting lower interest rates, should not be limited to any one type of credit market.

The ABA also believes that all participants in the credit markets should be allowed to participate in these new instruments. Specifically, the ABA believes that the so-called "government agencies" should be allowed to take part in the CMS market. Currently, the Federal National Mortgage Association (Fannie Mae) and its brethren are major players in the secondary mortgage market. Their participation in the CMS market will only serve to promote the health and vitality of the market. We can see no reason to deny them this access.

Several months ago, the ABA joined with other interested organizations to urge you to proceed on these bills, then in the drafting stage. We commend you for holding these hearings and urge the Committee and the Congress to advance these vital pieces of legislation. Prompt action will serve to benefit borrowers seeking affordable credit. With the support of the Administration on the basic proposal, we would hope that expeditious passage of such legislation could be realized.

Thank you for this opportunity to present our views. If you have any questions, please do not hesitate to contact us.

Sincerely,

Edward L. Yingling
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American Financial Services Association

February 14, 1986

Honorable John H. Chafee
Chairman
Subcommittee on Taxation and Debt
  Management
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The American Financial Services Association (AFSA)* appreciates the opportunity to comment on S. 1959, the "Secondary Market Tax Amendments," which you have sponsored and S. 1978, the "Recovery Act for Mortgage and other Asset-Backed Securities," sponsored by Senators Cranston and D'Amato. AFSA respectfully requests that these comments be included in the hearing record.

AFSA favors the authorization of multi-class pass-through securities as a means of furthering the securitization of all types of credit instruments. We believe that the current tax treatment of such securities, which forces the issuer to treat such securitization as a debt, discourages issuance.

While AFSA welcomes S. 1959's removal of such barriers to the securitization of real estate receivables, we urge the Subcommittee to adopt S. 1978's approach of allowing the securitization of all types of receivables.

AFSA members hold over $30 billion in real estate receivables, primarily home equity loans, and hold over $120 billion in other types of consumer credit. This ranges from motor vehicle financing, the financing of other durable goods, the issuance of credit cards, the financing of manufactured homes (still considered personal property in some states) to the extension of virtually all types of closed-end consumer credit.

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*. AFSA represents over 511 companies operating more than 11,700 offices serving the public throughout the country. AFSA membership is highly diversified, ranging from independently-owned consumer finance offices to national delivery companies engaged in unsecured direct lending, second mortgage lending, consumer banking, industrial banking and the financing of the sale of durable goods.

Non-real estate backed assets have already proven to be sufficiently creditworthy to support securitization. To date, one AFSA member company, General Motors Acceptance Corporation, has launched a $524 million issue secured by automobile loans. Another AFSA member company, Nissan Motor Acceptance Corporation, has announced it will offer a $100 million issue also secured by automobile loans.

A commercial finance company, Sperry Financial Services, has issued securities backed by computer equipment leases. Several banks have also packaged their automobile loans and issued similar offerings.

Easing securitization of these assets will give additional AFSA member companies access to new sources of capital. S. 1978 addresses this need and AFSA urges this Subcommittee to approve this vital legislation.

Sincerely,

Robert B. Evans

Robert B. Evans
President

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* Immediate Past Chairman
† Honorary

January 29, 1986

Honorable John H. Chafee
Chairman
Subcommittee on Taxation
and Debt Management
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Pursuant to the Subcommittee's press release announcing public hearings on January 31, 1986, regarding S. 1839, the American Mining Congress wishes to submit its views on the bill for the Subcommittee's consideration.

The American Mining Congress is an industry association representing all segments of the mining industry. It is composed of (1) U.S. companies that produce most of the Nation's metals, coal and industrial and agricultural minerals; (2) companies that manufacture mining and mineral processing machinery, equipment and supplies; and (3) engineering and consulting firms and financial institutions that serve the mining industry.

The American Mining Congress strongly opposes S. 1839 and urges that the Subcommittee not endorse it. The bill is both bad tax policy and bad public lands policy.

Tax Policy

The bill would deny the normal tax treatment accorded hard mineral investments and activities if the activity is located in what the bill labels an "environmental zone." Exploration and development costs would have to be capitalized and recovered through cost depletion rather than expensed. The percentage depletion allowance would be disallowed. Slower than normal depreciation deductions would be mandated. The investment tax credit would be disallowed for any property used in the zone. Normal tax-exempt state and local bond treatment would be denied if the bonds were used to finance facilities within an "environmental zone."

Thus, the tax law would be changed to make the conduct of mining activity within a so-called environmental zone substantially more costly than the conduct of the activity elsewhere. The effect of this discriminatory treatment would be to sharply curtail, if not eliminate, mining activities within these environmental zones.

The change in tax treatment mandated by the bill has nothing to do with and is not justified by sound tax policy. Indeed, the bill moves contrary to sound tax policy because it embarks on an entirely new direction of use of the Internal Revenue Code for wholly-non-tax, non-revenue raising purposes.

When one considers the definition of "environmental zone" contained in the bill, where mining activity would be effectively precluded by the bill, it is clear that the purpose of the bill is simply to prevent mining, and other similar activities, on large areas that have not been withdrawn from mining activity or industrial activity pursuant to the public land programs of the United States.

If it is the public lands policy of the United States to withdraw the areas defined in the bill as "environmental zones" from mining activity, that should be done directly, not by the backdoor route of using the tax system as proposed in S. 1839.

Public Lands Policy

One third of the nation's land area, approximately 750 million acres, is public lands. These lands contain stores of mineral and non-mineral resources that are useful and important to the United States and its people.

Yet, more than 50 percent of the public lands have been entirely or partially closed to mineral exploration and development for a variety of reasons.

Minerals are the keystone of the nation's economy. They are essential for production and delivery of our most basic needs--energy, food, water, shelter, and manufactured goods.

Public lands have been an important source of minerals in the past because the western United States, where a large percentage of federal lands are located, is heavily mineralized. They contain most of the identified resources of many of the metallic minerals.

There are two factors that greatly affect the mining industry's ability to find and produce minerals. First, it is dependent on the geologic availability of ore deposits. No amount of money expended can make it possible to extract metalliferous ores from rocks in which they are not present. Second, if the deposits are to be found, the mining industry must be provided access to lands where they may occur.

S. 1839, if enacted, would further restrict the availability of federal lands and thus add to the cumulative depressing effect of land withdrawals on future mineral production.

S. 1839 as drafted does not accurately perceive the role of the nation's public lands. Indeed, the measure's definition of "environmental zone" [(sec. 280 H(d)] is an entirely new land classification. S. 1839 amends the Internal Revenue Code, thus, the new definition would be included there and not in the appropriate land management statutes. The American Mining Congress suggests that the Committee on Energy and Natural Resources is the appropriate body to consider this definition of a new land management category.

The American Mining Congress is particularly concerned that the measure includes the National Forest System in its definition of "environmental zone." The National Forest System has been designated by Congress to be managed under the principle of multiple use. Multiple use is defined as a combination of balanced and diverse resource uses that takes into account the long-term needs of future generations for renewable and nonrenewable resources, including the need for minerals. S. 1839 would repeal this long-standing policy of multiple use with respect to newly acquired National Forest lands.

It is possible that large areas could be put off-limits. For example, the proposed large-scale exchanges of federal lands for state lands in the western U.S. and the proposed Bureau of Land Management/Forest Service land interchange involve millions of acres that could be included in the National Forest System.

Another problem would result when the Forest Service acquires inholdings. These acquisitions are aimed at more efficient management, not because these lands have some special environmental value.

The bill also includes under its definition of "environmental zone" any area designated by the Secretary of Interior as critical habitat under the Endangered Species Act. If, for instance, the Secretary decided to designate grizzly bear critical habitat, under the definition contained in S. 1839, hundreds of millions of acres of public lands would be withdrawn from the operation of the mining and mineral leasing laws and thus drastically exacerbate the problems brought about by excessive land withdrawals.

Conclusion

S. 1839 does not make sense either from a tax policy standpoint or from a public lands policy perspective. Accordingly, the bill should not receive the approval of the Subcommittee on Taxation and Debt Management.

Respectfully submitted,

Dennis P. Bedell

Dennis P. Bedell
Chairman, Tax Committee
American Mining Congress

STATEMENT OF ATLANTIC RICHFIELD COMPANY
ON S. 1839
PRESENTED FOR THE HEARING RECORD
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
of the
SENATE COMMITTEE ON FINANCE

Atlantic Richfield Company appreciates this opportunity to present its views on S. 1839, legislation which proposes to reduce or eliminate certain allowances available in the tax code to oil, gas and mining activities if the business operations qualifying for those allowances take place in certain "environmental zones." As a Company involved in the exploration for and development of oil, gas and coal resources, Atlantic Richfield Company has a keen interest in the outcome of this legislation.

S. 1839 would modify the manner in which depreciation, amortization and depletion deductions may be calculated and would disallow investment tax credits and a variety of deductions including the expensing of depreciable assets, soil and water conservation and land clearing costs, intangible drilling and development costs, and tertiary injectant costs, if the amounts paid or incurred occur on property located predominantly within an "environmental zone."

The apparent purpose of this legislation is to make oil, gas and mining activities so unattractive economically, by removing many of the incentives current tax law provides, that resource development companies will not proceed with any activities in these "environmental zones." Atlantic Richfield Company strongly opposes this legislation and believes that the use of the tax code as a land-use planning tool for purposes of protecting certain arbitrary "environmental zones" is inappropriate.

There currently exist a number of federal laws whose sole and express purpose is to insure that sensitive environmental areas are protected from any deleterious effects that might be associated with exploration and development activities. In addition to the large number of federal environmental protection and land-use planning laws, there are numerous state statutes that impose even more stringent standards on industry operations. To mention a few of the federal laws, the Clean Water Act, the Clean Air Act, the Coastal Zone Management Act, the Endangered Species Act and the National Environmental Policy Act, require industry to conduct studies and obtain permits, before activities actually begin, to insure that any effects of the proposed operations will be within the limits established by the regulations that have been carefully developed to implement the goals and objectives of these many comprehensive statutes. During the permitting process, if it is determined by the agency charged with implementing the law that a proposed activity cannot be conducted without violating the regulations, the permit will be denied and the project will be prohibited.

Our experience has been that oil and gas activities are compatible with sensitive environments when properly designed and operated. Atlantic Richfield Company is proud of its operating record in sensitive environments such as offshore California, the Gulf of Mexico and the North Slope of Alaska. We believe that the existing environmental regulatory framework provides adequate protection for environmental resources.

If additional protection is believed to be needed for these newly proposed "environmental zones", those concerns should be expressed forthrightly in the context of the current environmental regulatory framework and debated openly as a policy issue. Should the debate reveal some environmental protection need is going unfulfilled, a program should be designed to satisfy that need.

Exploration in remote areas has become quite costly and approaches the point where such activities may be discontinued. These areas have been the source of much of the nation's recent energy supplies, without which we would be even more dependent on foreign supplies of crude oil and natural gas. By arbitrarily singling out certain geographic areas as "environmental zones" in the manner proposed by this legislation, the potential for the development of substantial hydrocarbon resources is reduced. For instance, had S. 1839 been in effect earlier, it is possible that the Prudhoe Bay and Kuparuk fields would not have been discovered and developed in time to cushion the shortages of the 1970's, and the major discoveries offshore California could have been delayed, or might not have occurred at all, depending upon the definition of "environmental zone" finally agreed upon, since these fields are located in areas which could be classified as environmentally sensitive. Much of the nation's future domestic energy resources may be found in so-called sensitive areas and to penalize companies or individuals for exploring where they are otherwise permitted to go is to further reduce the nation's exploration effort, guaranteeing long term energy shortages.

Today's oil surplus exists not because the U.S. is self-sufficient in energy, but rather because there is a surplus of oil on the world market. But as history has shown, these surpluses can quickly turn to shortages. It is important that Congress, acting out of a false sense of security, not erect policy barriers today that jeopardize the energy security of tomorrow. Atlantic Richfield Company participated in the development of, and is in full agreement with, the statement of the American Petroleum Institute (API) which describes in greater detail the need to develop land use policies that encourage exploration and development of the nation's oil and gas resources. That testimony was presented before the subcommittee on January 31, 1986.

S. 1839 would not afford greater protection to the "environmental zones" it proposes to create. Rather, it would establish a land withdrawal program that denies industry the opportunity to evaluate the hydrocarbon and mineral resource potential of an area. Atlantic Richfield Company does not believe this is sound public policy.

S. 1839 is an unnecessary land withdrawal program, based on ill-defined concerns, that would amend the tax code absent a straight-forward deliberation about the merits of the code. For these reasons, Atlantic Richfield Company strongly opposes this legislation.

c

CITIBANK

Citibank N.A
399 Park Avenue
New York NY
0043

John F. Rolph, III
Vice President-
Tax Legislation

March 7, 1986

The Honorable Alan Cranston
United States Senate
112 Senate Hart Office Building
Washington, DC 20510

Dear Senator Cranston:

This is in reply to your staff's inquiry concerning Citibank's position on legislation to clarify to tax treatment of mortgage-backed securities. At the time of the January 31, 1986 hearing before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, Citibank's views in support of such legislation were set forth in a telegram to Subcommittee Chairman John Chafee. A copy of the telegram, which was included in the hearing record, is attached for your information.

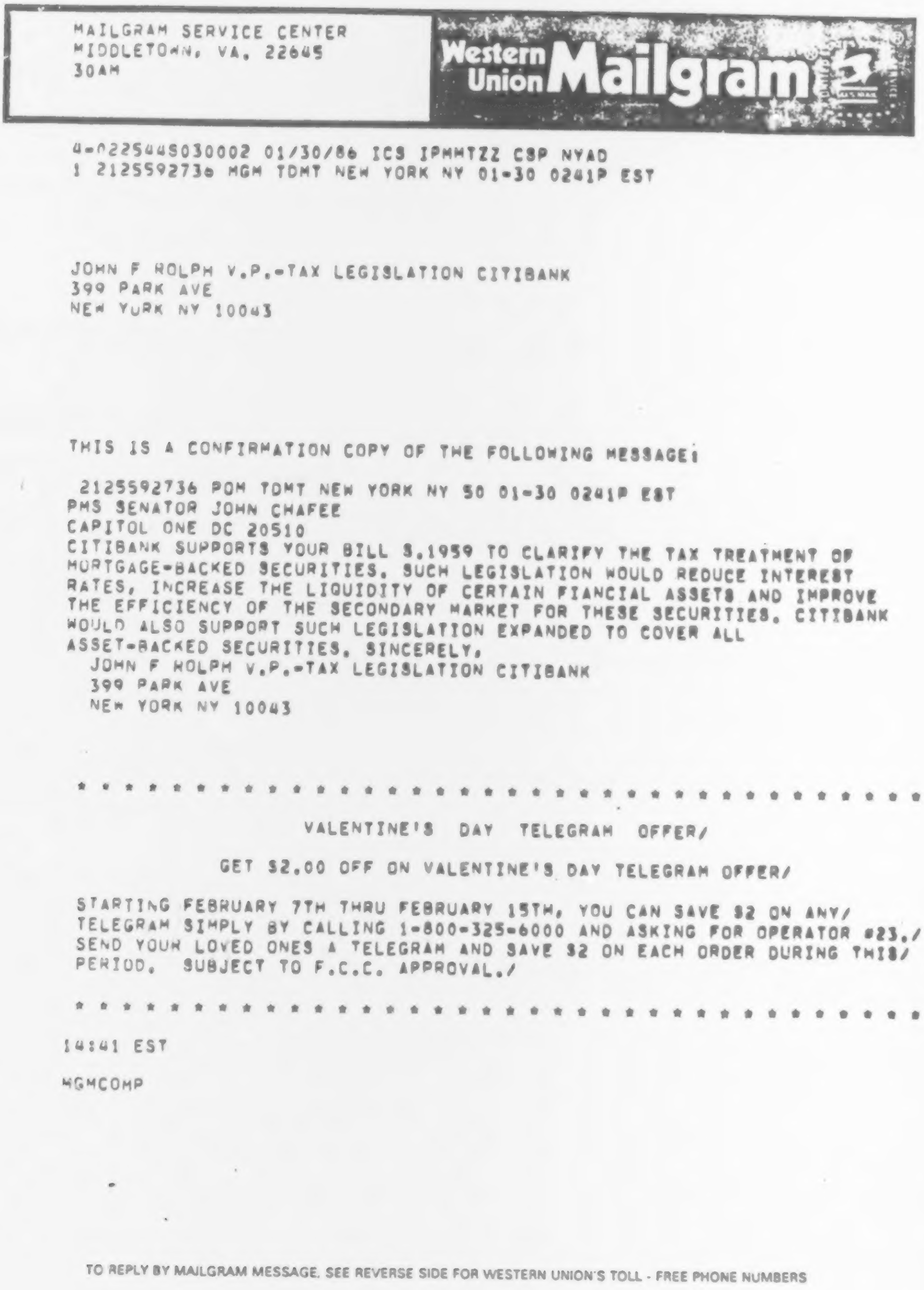
As indicated in the telegram, Citibank would also support such legislation expanded to cover all asset-backed securities, consistent with the scope of your bill, S. 1978.

Sincerely,

Ted Rolph
John F. Rolph, III
Vice President - Tax Legislation

Suite 350
1200 New Hampshire Avenue, NW
Washington, DC 20036
(202) 293-4855

Attachment



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JOHN F ROLPH V.P.-TAX LEGISLATION CITIBANK
399 PARK AVE
NEW YURK NY 10043

THIS IS A CONFIRMATION COPY OF THE FOLLOWING MESSAGE:

2125592736 POM TDMT NEW YORK NY 50 01-30 0241P EST
PMS SENATOR JOHN CHAFEE
CAPITOL ONE DC 20510

CITIBANK SUPPORTS YOUR BILL S.1959 TO CLARIFY THE TAX TREATMENT OF MORTGAGE-BACKED SECURITIES. SUCH LEGISLATION WOULD REDUCE INTEREST RATES, INCREASE THE LIQUIDITY OF CERTAIN FIANCIAL ASSETS AND IMPROVE THE EFFICIENCY OF THE SECONDARY MARKET FOR THESE SECURITIES. CITIBANK WOULD ALSO SUPPORT SUCH LEGISLATION EXPANDED TO COVER ALL ASSET-BACKED SECURITIES. SINCERELY,

JOHN F ROLPH V.P.-TAX LEGISLATION CITIBANK
399 PARK AVE
NEW YORK NY 10043

* *

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1776 G Street NW
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202/789 4700

Freddie
Mac
Federal
Home Loan
Mortgage
Corporation

February 11, 1986

Honorable John H. Chafee
Chairman
Senate Finance Subcommittee on Taxation
and Debt Management
219 Senate Dirksen Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

The Federal Home Loan Mortgage Corporation, Freddie Mac, appreciates the opportunity to let you know of our interest in S.1959 and S.1978 which are designed primarily to provide certainty and clarity to the tax treatment of multiple class mortgage-backed securities. Though S.1978 also provides for securities backed by other types of indebtedness, we will confine our comments to those backed by real property.

We are interested in this issue for two basic reasons. First, we are interested in any legislation affecting housing since Freddie Mac is a congressionally-chartered corporation set up to increase the flow of funds to housing through the secondary mortgage market. We have been very successful in this endeavor - issuing over $122 billion of mortgage pass-through securities since 1971.

Second, we have an almost "parental interest" in any effort to encourage the use of multiple class securities since we pioneered the first collateralized mortgage obligation (CMO), the forerunner of the multiple class securities which the two bills under consideration would promote.

In 1982, there was increased congressional attention to the problem of attracting non-traditional investors to housing. We at Freddie Mac grappled with that problem and found that large investors, such as pension funds, required investment instruments with cash flows more consistent with those of most corporate bonds - that is, cash flows that can be short or long term in maturity and are predictable. These kinds of cash flows can only result from greater call protection than that offered by mortgage pass-through securities since mortgages frequently prepay.

Freddie Mac responded to these investor concerns by designing a CMO with a tiered maturity structure and guarantee that translated to a more predictable rate of return and a degree of call protection other pass-through securities lack. Various types of investors found that they could choose the class best suited to their investment objectives - what Business Week called "selling mortgages by the slice." Selling mortgages by the slice also provided thrifts with an important restructuring tool, enabling them to better match their assets to their liabilities. And so we found ourselves at the forefront of a not-so-quiet revolution in mortgage related securities.

The CMO has been successfully replicated by others in the marketplace. Over 80 percent of the $29.4 billion in CMOs issued since 1983 through September, 1985 represent issuances by others in the marketplace besides Freddie Mac.

To further this development, it is important that any legislation affecting these relatively new investment instruments not create any confusion for investors or issuers. To that end, we would like to comment on several general aspects of the bills that we feel need further technical clarification or simplification.

1. How would each class of investors account for tax purposes for cash payments and economic benefits derived from a multiple class security?

Under S.1978, it is not clear what tax accounting rules should be used by investors purchasing interests in such trusts - original issue discount ("OID") rules, market discount rules, or some other set of rules.

S.1959 stipulates OID rules, but proposes formulas for several calculations which appear overly complex for many mortgage market investors. For potential investors making investment decisions, unnecessarily complex rules could be a real disincentive to this type of investment. The responsibility for the mortgage - related calculations will fall to the issuer, who will have to report taxable income such as OID to investors, and also to all middlemen reporting this information. Requirements on information reporting should also address that required of the middleman.

These calculations will require sophisticated computer systems to accommodate both the volume (Freddie Mac alone buys an average of 2000 loans a day and has approximately three million loans currently backing securities) and complexity of the transactions. The cost of calculating this information could be considerable. Depending upon the ultimate content of these rules, we could be required to develop new information systems, which could be extraordinarily expensive.

2. Under S.1959, how will certain types of information be made available or computed by investors actively trading securities in the secondary mortgage market?

S.1959 expands both the range of investors to whom issuers of CMS instruments must annually report tax data and the type of tax data which must be reported. However, it is not clear: (1) how investors can be effectively informed of the composition of the portfolio supporting a particular CMS to permit proper calculations of gain or loss upon the sale of CMSs throughout the year; and, (2) how investors could accurately compute their adjusted tax basis in the CMS on the date of sale when it is sold in the middle of an accrual period.

In addition, it should be noted that tax compliance provisions of this bill would impose a new annual filing requirement, similar to Form 1099, on issuers of mortgage pass-through securities with OID. However, unlike current reporting requirements for issuers of CMOs, these new rules would not waive reporting to corporate holders of debt obligations subject to the OID rules.

3. Under S.1978, phantom income questions are resolved for issuers of multiple class pass-through securities. However, these issues remain open for issuers of CMO debt.

S.1978 eliminates phantom income issues for issuers of multiple class pass-through securities by treating such securities as sales of the underlying assets. However, the bill does not clarify this issue for CMO debt securities. This would result in continued uncertainty over phantom income reporting for such debt issues, thereby possibly creating some inconsistency between multiple class pass-through securities and those issued in the form of CMO debt, despite comparable economic structures.

4. Expanded definitions of "temporary investments" and "guaranty payments" would be helpful clarifications.

Neither bill defines the term "temporary investments". These investments are crucial to the issuers' ability to modify the timing of cash flows from, for example, monthly mortgage payments to semi-annual bond-like payments. Since temporary investments may be held in qualified trusts supporting multiple class securities under both bills, it would be important to state clearly the latitude given those trusts making such investments. Either the proposed legislation or the supporting technical explanation should clarify issuers' ability to manage appropriately the trust assets.

S.1978 offers "guaranty payments" as an acceptable proceed of a financial instrument which may be held by a qualifying trust. This may allow issues of new multiple class securities with minimum repayment guarantees (such as those on certain Freddie Mac CMOs), but it is not clear since this term is mentioned only in the technical explanation of the bill and not defined. S.1959 does not specifically mention minimum repayment guarantees and so it is similarly unclear to what extent they would be allowed under that bill.

I hope these comments and questions will be helpful to you and the Members of your Subcommittee as you consider S.1959 and S.1978.

During this process, we would be happy to work with you in any way you find useful. In addition, over the next few months, we will attempt to simulate compliance with the bills in an effort to uncover any anomolous results. We would appreciate an opportunity to provide additional comments at that time.

Sincerely,

Leland C. Brendsel

Leland C. Brendsel
Acting President

STATEMENT OF THE
INVESTMENT COMPANY INSTITUTE
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
ON S. 1959 AND S. 1978

FEBRUARY 7, 1986

On behalf of its mutual fund members, the Investment Company Institute* (the "Institute") respectfully submits the following comments on S. 1959 and S. 1978, two bills relating to the tax treatment of mortgage related and other asset backed securities.

Both S. 1959 and S. 1978 provide for an alternative method of pooling mortgages and, in the case of S. 1978, other obligations, which would eliminate the disadvantages of the pooling methods existing under current law. These entities -- pools of mortgaged-backed securities -- share fundamental attributes with other types of pooled investment vehicles. Each is a pool of assets, managed by an investment manager, with interests in the pool sold to investors. It is our view these pooled investment vehicles present similar public policy concerns and issues of consumer protection -- the need to provide potential investors with information on which to base their investment decisions, the need to protect the physical integrity of assets of the pool, and the need to prohibit self-dealing and conflict of interest transactions by the managers of the pool. Therefore, like other pooled investment vehicles, these entities should be regulated under the Investment Company Act of 1940. The investor protections provided by the Act enhance investor confidence. For example, mutual funds, subject to regulation under the Investment Company Act, have grown from $400 million in assets in 1940 to over $500 billion today.

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* The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 1,455 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. Its mutual fund members have assets of about $440 billion, accounting for approximately 90% of total industry assets, and have over 20 million shareholders.

We are, however, concerned that the staff of the Securities and Exchange Commission has administratively been exempting from the Investment Company Act certain pools of mortgaged-backed securities without giving adequate consideration to the purposes and policies underlying that Act. The Committee should, therefore, direct the SEC to give these standards -- the protection of investors and the purposes and policies of the Act -- due consideration. Moreover, these standards should be applied not only in connection with the types of pooled investment vehicles which are the subject of these bills, but for all other types of pooled investment vehicles subject to the Act as well.

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The Importance for Savings and Loan Associations of Federal Tax Legislation To Authorize Multiclass Pass-Through Securities and To Improve Multiclass Debt Securities

March 1, 1986

Introduction

Ever since they came into existence, savings and loan associations have had to contend with three interrelated risks: interest rate risk; liquidity risk (the risk of excessive withdrawals by depositors that lose confidence in the institution); and credit risk (the possibility of defaulting loans).

Until recent years, however, thrifts functioned in an environment that greatly minimized these hazards. Interest rates were relatively low and stable. Because savings institutions were allowed to pay slightly higher interest rates than banks for deposits, there was a virtual absence of competition between the two types of institutions. With their deposit base secure and interest rates relatively stable, thrifts were practically assured a comfortable profit on their long-term, fixed-rate mortages.

Beginning in the late seventies, these conditions changed swiftly. Interest rates soared, forcing thrifts to pay dearly for short-term deposits, depressing the value of their mortage portfolios and lowering operating income. At the same time, government deregulation created fierce competition between thrifts and other financial institutions for deposits. Unfortunatley, casualties have been high.

Given the current situation in U.S. financial markets, it is incumbent on savings and loans to manage these three risks effectively if they are to survive, let alone prosper. Several legislative proposals now before the Congress, S.1959 and S. 1978, that authorize the use of multiclass pass-through securities and improve multiclass debt securities will help thrifts to better manage these risks.

Interest Rate Risk

One of the greatest risks that thrifts face is interest rate risk. It is created by the funding of longer-term fixed rate assets by shorter-term deposits and borrowings. The substantial portion of these interest rate insensitive assets are held in the form of real estate, consumer and automobile loans. Some thrifts partly manage the risk of these holdings by relying upon asset sales. Asset sales can improve the profitability of thrift institutions. Asset sales can reduce the thrift's portfolio risks to interest rate swings by improving the maturity match of its assets and liabilities. If mortgages, receivables and other assets were allowed to be used in multiclass pass-through securities thrifts could use this new tool to securitize and sell any of the assets in their portfolios, if and when necessary, and, thus, reduce their interest rate risk. The legislative proposals would also facilitate the creation of shorter-term securities that would be ideal investments for thrifts trying to better match assets and liabilities by garnering shorter-term assets.

Liquidity Risk

Asset sales can increase a thrift's liquidity by quickly converting loans into cash. The legislative proposals before the Congress would facilitate the sale of such assets through securitization. Although securitization is important for new mortgage and other loans, it is also important as a financial liquidity tool for thrift institutions with large portfolios of older loans. Thrift institutions can profitably utilize these securities to borrow against these existing portfolios of older fixed-rate loans. This source of funds can facilitate their origination of new fixed or adjustable rate mortgages or diversification into other forms of lending.

The legislation before the Congress would also facilitate the use of multiclass collateralized borrowing sources by reducing "phantom income" to potential issuers such as savings and loan associations. This "phantom income" problem of "income without gain" can be quite serious where the collateral is seasoned mortgages that bear less than current market interest rates.

In addition, in a multiclass mortgage or other asset-backed bond issue that is classified as debt for tax purposes, thrift issuers are often required to retain an "equity interest" in the mortgages or other loans. In other words, the thrift issuers cannot fully borrow against the value of the mortgages or other loans and must retain a residual interest in the mortgages. With less cash received up front, the multiclass mortgage or other asset-backed bond is less useful as a financial liquidity device for thrifts seeking to restructure their portfolios. This equity requirement also imposes additional legal accounting and capital costs to the thrift issuer. The legislative proposals before the Congress resolve this problem.

Credit Risk

Asset sales can boost the operating income of savings and loan institutions by increasing their fee income through the origination (origination fees), securitization (arbitrage) and servicing (servicing loan fees) of loans. This mortgage banking activity can substantially reduce the risk to thrifts of holding assets in portfolio. The risks of delinquency and default are passed on to investors.

It is difficult to overstate the increasing importance to the nation's thrifts of "securitization"--the process of turning pools of mortgages and other assets into securities, that can be sold to capital market investors. It is important to remember that in many cases it is only the ability to securitize and sell a mortgage or other loan to investors in the secondary market that allows local thrifts to make loans at competitive rates in a nationwide marketplace.

In addition with the expanded powers granted to the thrift industry in 1982, many thrifts are diversifying into originating automobile loans, other consumer loans and commercial loans as a way of reducing their portfolio risk and increasing their yields. However, risk is a function of knowledge and experience. Many thrifts are diversifying too rapidly into these new businesses. The result has been an increase in failures of thrifts, no longer as a result of liquidity problems, but as a result of bad assets.

The origination and sale of non-mortgage asset-backed securities to investors will help thrifts mitigate against loan losses on consumer and commercial loans that result from holding them in portfolio. It will help them gain experience in originating such loans by following the underwriting criteria of their investors.

Conclusion

Why is it essential for savings and loan associations to be able to have a wider range of options in the mortgage and other asset-backed securities market? The answer is that asset sales facilitated by multiclass pass-through securities and improvements in the mortgage and asset-backed debt markets provide ways for thrifts to reduce interest rate risk, liquidity risk and credit risk. The legislative proposals now before the Congress, S. 1959 and S. 1978, together would provide helpful ways to reduce these risks.

MONTANA PETROLEUM ASSOCIATION
A Division of the
Rocky Mountain Oil and Gas Association

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Billings, Montana 59103
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Janelle K. Fallan
Executive Director

February 12, 1986

The Honorable John Chaffee
Chairman, Subcommittee on Taxation and Debt Management
United States Senate
Washington, DC 20510

Dear Sen. Chafee:

The Montana Petroleum Association requests that this letter be included in the hearing record on SB 1839.

We are concerned about this bill, to create environmental zones by making changes in the tax code and the possible impact on independent operators in Montana.

Independents play a very large role in exploration and production in this state. The depletion provision in the bill would especially disadvantage independent operators. While major oil companies are not permitted percentage depletion under existing law, independent operators are allowed such deductions. The depletion provision of S 1839 would tend to discourage independents from exploring promising areas that might be designated as environmental zones.

It seems clear that the intent of S 1839 is to prohibit mineral exploration and development within areas designated as "environmental zones." High risk mineral activities would be made more expensive by the substantially reduced ability to recover development capital. Energy companies (again, think of Montana's independent operators) would be barred from taking the depreciation and amortization allowance and from writing off any depreciations on their assets. Favorable tax treatment would also be withdrawn for intangible drilling costs, and development and tertiary injectants.

It seems to the Montana Petroleum Association a questionable application of an already complex tax code to use it as a land withdrawal mechanism or land use planning tool for environmental purposes.

Thank you for your attention to this matter.

Sincerely,

Janelle K. Fallan

Janelle K. Fallan
Executive Director

National Association of Home Builders
15th and M Streets, N.W., Washington, D.C. 20005
Telex 89-2600 (202) 822-0200

February 11, 1986

The Honorable John H. Chafee
Chairman
Senate Subcommittee on Taxation
and Debt Management
567 Dirksen Senate Office Building
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman,

On behalf of the National Association of Home Builders, I am submitting a statement for the hearing record of January 31, on the subject of multiple-class mortgage-backed securities. Due to our interest in this subject, we would like to have our comments included in the printed hearings.

Thank you for the opportunity to submit a statement on this important issue.

Sincerely,

Kent Colton

Kent Colton
Executive Vice President

KC/das
Enclosure

Mr. Chairman and Members of the Committee:

The National Association of Home Builders, a trade association representing 137,000 members, is pleased to submit a statement for the hearing record concerning multiple-class mortgage-backed securities. NAHB strongly supports the goals of S. 1959, introduced by Senator Chafee, and S. 1978, introduced by Senator Cranston, both of which will eliminate impediments to growth in the market for mortgage pass-through securities -- a major component of the overall secondary mortgage market.

In the past, the role of the secondary market was primarily to help solve regional differences in the cost and availability of mortgage credit. Today, the secondary mortgage market links the capital and mortgage markets largely through sales of mortgages in the form of pass-through securities that have attracted investors from outside the traditional mortgage investment community.

Before presenting the statement, I would like to briefly address recent efforts aimed at weakening the federally related secondary market participants -- the Federal National Mortgage Association (FNMA), and the Federal Home Loan Mortgage Corporation (FHLMC), and the Government National Mortgage Association (GNMA). Last year, NAHB worked aggressively in opposition to a proposal to impose or increase user fees on these secondary market entities. Strong secondary market outlets for mortgage loans to moderate-income homebuyers are imperative in order to provide affordable funds for this group of purchasers. If the Government imposes user fees on FNMA and FHLMC and increases fees for GNMA, then the cost would be passed through to homebuyers and would reduce the number of families that could qualify for a home. The effect of such fees would fall particularly hard on first-time homebuyers. We are very concerned about the user fees on housing programs that have been proposed in the Administration's FY '87 budget. These fees are even higher than those in the proposal that was rejected last year. We must ca[illegible]ly oppose these efforts to weaken or eliminate the programs wh[illegible]ve made home ownership possible for so many American families.

It is equally important that these secondary market purchasers be allowed to participate in mortgage-backed security programs on an equal footing with private conduits. Although both S. 1959 and S. 1978 allow participation by FNMA, FHLMC and GNMA, the tendency of some to oppose this participation makes it important to further clarify NAHB's position. NAHB strongly supports the inclusion, directly and indirectly, of FNMA, FHLMC, and GNMA in these transactions and will actively oppose any provision that disallows their full participation. FNMA, FHLMC, and GNMA, created by Congress to develop the residential secondary market, have been important elements in the continuing growth and evolution of secondary market activities. In these secondary market participants, the Congress has made available a tool through which cost-effective financing can be provided. FNMA, GNMA and FHLMC largely complement rather than compete with private lenders and suppliers of funds, and we cannot support an effort to put the housing finance markets in a position in which it is more profitable to serve the largest and wealthiest customers.

Mortgage Backed Securities under Current Law

The first mortgage pass-through securities were issued in 1968. By the end of 1985, outstanding mortgage securities had grown to nearly $400 billion. Since the first issuance, the market has developed a variety of instruments which have attracted investors because of their safety, yield and liquidity.

The development of mortgage-backed securities has increased the supply of mortgage money going into home loans by providing originators with an outlet for their portfolios of residential mortgages. Furthermore, as the secondary market has become more sophisticated and as more products have been introduced, the relative cost of mortgage money has decreased.

Second, the liquidity provided to financial institutions, particularly through mortgage/securities SWAPs, has provided originators with an alternative for their mortgage loan portfolios. This has been particularly helpful as institutions -- thrifts in particular -have attempted to restructure their assets and reduce maturity mismatch. Without the mortgage-backed securities market, it is doubtful that a substantial number of 30-year fixed-rate mortgages would still be available. We would expect additional positive influences on the mortgage market if tax laws are updated to reflect the concepts proposed in the two bills being considered.

Current tax rulings that apply to mortgage-backed securities generally were designed for other types of securities and have made tax law applications cumbersome to both investors and issuers. The introduction of collateralized mortgage obligations (CMOs) in 1983 by the Federal Home Loan Mortgage Corporation allowed a certain degree of flexibility to investors in mortgage-backed securities by permitting issuance of separate classes of instruments in quasi-maturity classes or "tranches" that appealed to different classes of investors. However, a CMO is a debt instrument for accounting purposes; the issuing institution retains ownership of the mortgages and issues bonds secured by the mortgages. This arrangement often requires over collateralization. Moreover, current original issue discount (OID) rules can create tax liability for some issuers that is not reflective of the flow of economic benefits being produced by the underlying collateral.

Pass-through trust arrangements hold a number of advantages over the current debt structure of CMOs for some issuers and investors. One advantage is that the institution sells the mortgages into a trust -- a real plus for institutions with limited capital positions that cannot show excessive leveraging on their books and with a desire to restructure asset portfolios. A second advantage is that purchasers of pass-through securities -- such as thrift institutions -- may [illegible] the pass-through securities as eligible mortgage assets [illegible] [illegible] federal laws and regulations that impose a "qualified lender test." In terms of homebuyers, the "maturity slicing" associated with multi-class pass-through securities can lower rates paid on mortgage loans, particularly when short-term rates are below long-term rates in the market.

Under proposed Treasury regulations, a mortgage investment trust qualifying for pass-through tax treatment must provide terms of investment that are essentially fixed when the trust is created, and where only one class of securities may be issued against the trust. It is mainly the multiple-class structure, however, that produces lower interest rates for homebuyers.

S. 1959 and S. 1978

NAHB supports both pieces of legislation being considered. These bills, while accomplishing the same bas[illegible]ective, approach MBS tax clarification differently. Each bill proposes a solution which will be more attractive than current law to investors in the secondary market as well as to issuers of the securities. Both bills provide for multiple classes of ownership which facilitate the predictability of payments to investors. Each would offer call protection through multiple-class mortgage-backed securities, as well as allow the sale-of-assets accounting treatment for multiple-class securities. Since investors would own the underlying collateral, taxation of phantom income at the issuer level would be eliminated. Moreover, neither bill requires over collateralization of the underlying assets.

Both S. 1959 and S. 1978 provide for a clarification of OID rules to permit the proper assignment of tax liability to parties receiving the economic benefit from the underlying collateral. On this issue, NAHB feels the OID regulations need to be specifically spelled out in the legislation in order to provide clear interpretation for the Department of Treasury. For this reason, we prefer the approach in S. 1959 which prescribes the regulations in legislative language rather than leaving that subject open to interpretation by the Treasury Department. A lack of specificity leaves the rule makers without clear direction, and could result in regulations not fully in line with the intent of Congress.

On the remaining differences, S. 1959 creates a new rust or pooling device, while S. 1978 amends requirements of the current "grantor trust" to permit multiple-class pass-through securities. Because both bills remove impediments in current tax law, we do not view one approach as superior to the other on these grounds.

Conclusion

In summary, NAHB would like to emphasize its strong support for the goals of both S. 1959 and S. 1978. Clarification and modernization of current tax applications for multiple-class, mortgage-backed securities will both increase the breadth and depth of secondary markets and exert a downward influence on mortgage interest rates, making it easier for homebuyers to obtain affordable mortgage credit.

NAHB specifically supports legislative instruction on OID regulations to remove any element of doubt regarding Congressional intent. In addition, specific legislative inclusion of FNMA, FHLMC and GNMA participation will assure equal secondary market access for lenders serving first-time and moderate-income households in our society.

NAHB appreciates the opportunity to submit this statement for the hearing record.

STATEMENT OF THE NATIONAL INHOLDERS ASSOCIATION

CONCERNING S.1839

PRESENTED TO

THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE SENATE FINANCE COMMITTEE

NATIONAL INHOLDERS ASSOCIATION

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The National Inholders Association (N.I.A.) believes the passage of S.1839 would have a deleterious effect on American environmental and economic policy. The N.I.A. represents thousands of people and groups who own property or hold an equity interest within the boundary of or adjacent to all types of federally managed lands or who are impacted by the management, regulation of or access to, those lands.

Our organization is a people-oriented association which recognizes that inholders have certain rights which they should not lose due to the generally involuntary imposition of usage restraints by the Federal government on how they can live on, work on or use their property. Mr. Chairman, in our opinion, S.1839 is a well-intended effort to protect land areas, for example, which are or may be critical habitats for potentially endangered species. What this bill fails to address is the negative impact it would have not only on inholders within federally-managed areas but on America's energy, mineral, timber and other vital industries.

The potentially catastrophic economics effect of this bill on hundreds of small communities nationwide renders it benefit negative. We suggest that in order to protect the rights of individuals or groups as well as the rights of certain often undefined species, environmental and land-use goals could best be reached in accordance with the current policies and aims such as those in the Clean Water, Clean Air and similar Acts as amended. The long-term objective of these Acts is to attain an equitable balance which addresses preservation, development and the minimization of pollution. Our Association believes that these interrelated factors should permeate our National Park, Wildlife Refuge, Forest, Wild and Scenic River and Wilderness Preservations systems.

We have and desperately need in the future land areas where we can carefully allow and support the environmentally-safe extraction of minerals, surface development which is compatible with local use and appropriate agricultural and consumer related activities.

The use of the tax code as a vehicle for adding a new protected land category, "environmental zones", is a means for advancing the social policies of people or groups who generally don't live on or are only remotely connected with the lands in question. The bill's premise that indirect tax subsidies such as the investment tax credit, accelerated depreciation, the amoritization of start-up expenses and others are inappropriate is inconsistent with the entire thrust of federal tax policy. To legislate an environmental goal through the tax code, in our opinion, would be to create a less than efficient law. We recognize that the tax breaks mentioned in S.1839, specifically those addressing sections 179, 280H, and 48A (defining section 38 property) of the Internal Revenue Code of 1954, are generally consistent with the tax breaks utilized by every association and environmental group appearing before this subcommittee. This legislation has the potential to blatantly discriminate against people or groups who own property or hold an equity interest within the boundary of or adjacent to a federally managed area or who are impacted by the management, regulation of or access to, that area. This could open up a fundamental question of legislative fairness.

In light of the Gramm-Rudman-Hollings Act, all Americans are aware that our Federal budget and tax policies need drastic revision. In our opinion, the passage of S.1839 would have a far greater negative long-term economic impact on all parties concerned than the potentially positive short-term revenue facets of this bill.

Members of our Association are close to unanimous in their concern that the questionable revenue and environmental enhancements gained, with all the accompanying publicity, are miniscule compared with the high probability that individuals and groups will suffer. If it is the intent of this bill to create an environmental policy through the tax code then the tax effects of this policy should be equally shared by all areas of the U.S. economy which currently takes advantage of these subsidies.

Mr. Chairman, though we respect your leadership on environmental and land use issues, however in this case the N.I.A. believes that S.1839 does not fairly advance any viable economic or environmental policy.

National Recreation and Park Association

STATEMENT OF

THE NATIONAL RECREATION AND PARK ASSOCIATION

BEFORE

THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF

THE FINANCE COMMITTEE

ON

S. 1839,

"ENVIRONMENTAL ZONE" LEGISLATION

JANUARY 31, 1986

3101 Park Center Drive • Alexandria, Virginia 22302 • *(703) 820-4940*

It is with great pleasure that the National Recreation and Park Association submits this testimony in support of S. 1839, to amend the Internal Revenue Code to provide that certain deductions and credits not be allowed for expenditures within an "environmental zone."

The National Recreation and Park Association is a national, non-profit organization engaged in a wide range of research, education, policy and program assessmnets involving parks and recreation. We have a membership of over 17,500 individuals, organizations and agencies which perform an array of civic, professional and technical functions to meet America's diverse recreation demands. For the most part, our members are associated with public recreation and park systems. We have affiliate organizations in each of the 50 states, Canada, Europe and Asia.

We commend Senator Chafee for his far-sighted efforts to preserve and protect our country's natural resources. It is highly appropriate that our tax code reflect Federal efforts to protect and enhance our valuable natural resources. While Federal legislation has made significant progress with the creation of the National Park System, the National Forest System, the Wild and Scenic Rivers System, Coastal Barrier areas and Historic Sites, the current tax code encourages development in many areas that are candidates for inclusion in one or more of these systems. S.1839 offers a reasonable and sensible approach to the present inconsistencies of Federal tax policy with other Federal legislation designed to protect critical environments. The bill does not seek to alter activities within a National Park or Forest, for example; it merely eliminates tax incentives for development in areas that are candidates for inclusion in one of the above mentioned systems.

NRPA concurs with the recommendations of other concerned organizations that the term "environmental zone" include other threatened ecosystems such as wetlands. We would also recommend that the definition include areas which are candidates for inclusion in the National Trails System and National Recreation Areas.

This legislation is especially appropriate in light of the fiscally conservative mood of the Federal government, as it would produce additional Federal revenues. Moreover, the bill allows for the goals of deficit reduction and environmental protection to be achieved simultaneously.

The Federal tax system can be written to either encourage or discourage land conservation measures. Adverse development of lands in or near an area of natural importance should not be encouraged through a tax code which provides accelerated depreciation or investment credits on construction equipment. This legislation would prevent these types of incentives in certain sensitive environments.

Other Tax Code Provisions

It is of further importance to note that S.1839 not only corrects inconsistencies of the tax code with other Federal legislation, it also corrects inconsistencies within the tax code itself. The tax code, under the Tax Treatment Act of 1980 (P.L. 96-541), allows deductions for the donation of real property to preserve open space for conservation purposes. By encouraging deductible gifts of interests in lands for conservation, public and private organizations have been able to protect thousands of acres of threatened natural systems.

Development Pressures and Land Acquisition

Several legislative attempts are being made to protect a wide range of valuable environments against ever-increasing development pressures. In these fiscally-conservative times however, opportunities are limited for the Federal government to acquire lands for conservation purposes.

For example:

* Although Congress easily passed legislation that would have authorized land acquisition for a Virginia wildlife refuge, President Reagan vetoed the bill (H.R. 1404) in January. The area, which is threatened by development, offers a critical habitat to a number of endangered bird species.

* Legislation was recently introduced by Senators Evans, Packwood, Hatfield and Gorton, to establish the Columbia River Gorge as a National Scenic Area, thereby affording the area protection from unbridled development. This type of legislative effort will undoubtedly encounter a good deal of opposition from those concerned with reducing the federal deficit.

Vital areas such as those described above deserve protection. Without the Federal funds needed to purchase lands for their protection, they will continue to be subject to development pressures. Yet the government can take steps to protect these areas without necessarily involving the expenditure of Federal dollars,

- by not encouraging, through tax incentives, their development and further decay. The urgency and pressure to actually acquire these natural areas would certainly be eased if development pressures were not as strong. Therefore, the elimination of tax credits for development in these areas, via S.1839 or similar legislation, would afford at least some protection to these areas without necessitating Federal acquisition.

Wetlands

Wetlands are widely recognized as valuable natural resources, critical to America's delicate ecosystems. The general public derives wetlands benefits through flood and storm damage control, erosion control, water quality improvement, recreation, and fish and wildlife resources. The protection of wetlands is undoubtedly in the public interest.

Nevertheless, urban and industrial development pressures continue to contribute to the loss of this valuable resource. Although the Federal government has expressed a strong interest in preserving wetlands for the future, it is an obvious inconsistency to promote their development by providing tax credits and similar deductions.

A recent Interior Department study (Wetlands of the United States: Current Status and Recent Trends- March 1984) described the status of wetlands in the U.S., detailing a number of cases where they have been destroyed by development pressures. Although wetlands play a critical role in flood protection and water quality maintenance when development accelerates in nearby upland areas, it remains a paradox that these wetlands become prime candidates for housing, business office complexes, and similar uses as nearby upland areas are exhausted. In many areas, wetlands represent the last large parcel of open space.

It is ludicrous for the Federal government to continue its current tax policy in such critical environmentally sensitive areas. The Office of Technology Assessment has concluded that "[t]ax deductions and credits for all types of general development activities provide the most significant Federal incentive for farmers to clear and drain wetlands." Therefore, we strongly urge the inclusion of wetlands in the definition of environmental zones.

Congress recognized the value of wetlands in the recently adopted farm bill. The so-called "swampbuster" provision of the law denies federal farm subsidies, loans or crop insurance to farmers who drain, fill or otherwise convert wetlands to agricultural use.

The question as to the definition of a wetland is easily addressed. It has been defined in other legislation, including the recently adopted Farm Bill, and has also been defined by the Fish and Wildlife Service. In addition, the Army Corps of Engineers' definition, based on the degree of ground saturation and type of vegetation, was recently reaffirmed as a part of a Supreme Court decision, United States v. Riverside Bay Homes.

Historic Preservation

With the proposed reduction in tax credits for historic preservation, it is especially crucial that any tax reform legislation not encourage the development or destruction of historically valuable properties and landscapes. Therefore, we are encouraged to see that an area designated by the Secretary of Interior as a national natural landmark under the Historic Sites, Buildings and Antiquities Act is included in the definition of an environmental zone in S.1839. To extend the protection of historically significant areas, we would also encourage the inclusion of properties with recognized historic value under the National Historic Preservation Act of 1966.

Barrier Islands and Deductions for Second Homes

In its appraisal of the tax code and the impacts of such on the environment, Congress should look carefully at the current tax deductions for second homes. Many second homes are built in environmentally attractive and/or sensitive areas which border nationally protected areas.

A perfect example of this problem is the development of barrier islands. Our nation's barrier islands represent fragile ecosystems that attract thousands of tourists and homeowners. There has been a tremendous migration toward the coastal islands over the last twenty years. The U.S. Department of Interior documented an increase in population of more than double the national rate between 1960 and 1970. This migration has put tremendous pressure on the islands - access roads, water supplies, and beach access are built to facilitate mans presence.

Such development often causes severe environmental problems. Erosion is hastened by pedestrian and vehicular traffic, causing property losses of $300 million annually.

The islands are worthy of protection - they offer unparalleled recreational opportunities, have scenic value, and provide unique habitats and food for hundreds of species of flora and fauna.

In many cases, the National Park Service and the Fish and Wildlife Service work to protect the natural integrity of the islands and to prevent any harmful development which might occur. The Department of Interior has recently proposed additional lands for inclusion under the Coastal Barriers Resource Act (CBRA). However, under S.1839, only lands that are presently included in the CBRA System would qualify as an environmental zone. Because of their valuable environmental qualities, we strongly recommend that areas proposed for inclusion in the CBRA system also be included in S.1839 as an environmental zone.

The Federal government continues to subsidize and encourage development on barrier islands, at least in part through current tax incentives. If the intent is to protect such natural areas for this and future generations, then certain existing tax incentives run directly counter to the public interest. Deductions for second homes are one form of many Federal tax incentives that offers a disincentive for environmental conservation. This issue certainly deserves the scrutiny of Congress.

Last, but certainly not least of all, it makes good fiscal sense to delete tax credits for development on Coastal Barrier Islands. Certain development projects can lead to disaster, particularly flooding. Disasters ultimately become an expense to the taxpayer as the Federal government must provide relief to local communities.

We thank the Committee for the opportunity to submit this testimony and appreciate its attention to our recommendations.

PETROLEUM ASSOCIATION of WYOMING

PETROLEUM ASSOCIATION OF WYOMING
a division of Rocky Mountain Oil and Gas Association

330 South Center, Suite 115
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Richard T. Robitaille
Executive Director
Wendy H. Frueauf
Associate Director

February 13, 1986

The Honorable John H. Chafee
Subcommittee on Taxation and Debt Management
Senate Committee on Finance SD-219
Dirkson Senate Office Building
Washington, D.C. 20510

Dear Senator Chafee:

On behalf of the members of the Petroleum Association of Wyoming, a division of the Rocky Mountain Oil and Gas Association, whose members account for more than 90% of the exploration and production in Wyoming, we submit the following comments on S.1839 and request that our letter be included in the hearing record.

We believe the intent of this legislation is to make exploration and development of mineral resources within areas designated as "environmental zones" so cost prohibitive as to preclude any further activity at all. This defacto withdrawal is accomplished by substantially reducing a company's ability to recover development capital, tax credits, slowing the rate of capital cost recovery, and by negatively affecting cash flow and internal rates of return. This use of the tax code as a land withdrawal mechanism and a land use planning tool for environmental purposes is, in our opinion, totally inappropriate. We already have in place substantial and effective public land laws and regulations which direct the management of federal lands. These existing frameworks and vigorous environmental protections coupled with industry's demonstrated ability to operate in a manner compatible with sensitive environments, make any further restrictions unnecessary.

This proposal would ultimately eliminate revenue-generating mineral activities on public lands, a result which would be highly undesirable at a time when federal budget balancing is a high priority. We are alarmed over the current trend to withdraw lands from, or to restrict, oil and gas activities on more and more of our public lands. Currently the petroleum industry is precluded from exploring or determining mineral potential on 300 million acres or nearly 40% of federal lands. This proposal would further restrict unlimited millions of additional acres.

Because independent operators are currently allowed the use of depletion deductions, while major companies are not, this bill is especially injurious to that segment of the petroleum industry. In addition, it is the independent who traditionally drills the wildcat exploratory well in the remote areas, locations likely under this proposal to be designated as "environmental zones". Thus, this bill selectively penalizes the independent operator very unfairly.

PAW concludes that this legislation is unnecessary, unwise and dangerously limits our ability to maintain domestic petroleum reserves by unwarranted denial of access to federal lands for exploration and development purposes. It should be defeated.

Sincerely,

R. T. Robitaille

Richard T. Robitaille

cc: Senator Alan Simpson
Senator Malcolm Wallop
Katherine T. Porter
D. Thomas Kidd

Sears, Roebuck and Co.
Corporate Governmental Affairs
Sears House
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RANDOLF H. AIRES
VICE PRESIDENT

202/737-4900

February 19, 1986

The Honorable John H. Chafee, Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

During the hearing regarding secondary market tax issues before the Senate Finance Subcommittee on Taxation and Debt Management, our witness, Robert Horner, testified that Sears is committed to the development of the secondary mortgage market. Mr. Horner also emphasized the critical need for Congress to clarify current tax law in this area. Sears believes that S. 1978 and S. 1959 are a step in the right direction.

Since that hearing, Sears has been requested to provide its position, for the record, on extending the issuance of multiple class pass-through securities by grantor trusts to other types of asset-backed instruments. Sears, therefore, submits this letter in response to that request and asks that the following be added to Mr. Horner's testimony for the record.

Sears believes that legislation is urgently needed in order to address the existing crisis related to the offering of mortgage-backed multiple class pass-through securities. In our estimation, no reasons exist to exclude the introduction of other asset-backed instruments from that market. Indeed, including other assets such as consumer receivables would be a positive development both from an investment and a funding perspective. Sears is concerned, however, that this issue not impede or delay the passage of pending legislation.

Thank you for your support, Mr. Chairman, on this vital issue. Sears appreciates this opportunity to express its position on this issue.

Sincerely,

Randy Aires

cc: Members of the Subcommittee
Senator Cranston
bcc: Carolyn Jordon ✓

ALLSTATE INSURANCE GROUP · COLDWELL BANKER REAL ESTATE GROUP · DEAN WITTER FINANCIAL SERVICES GROUP
SEARS MERCHANDISE GROUP · SEARS WORLD TRADE

TRUE OIL COMPANY

RIVER CROSS ROAD

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2/26

February 21, 1986

The Honorable John H. Chafee, Chairman
Subcommittee on Taxation and Debt Management
Room 219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman,

The following are our comments on your bill -- S. 1839. We request that our comments be included in the hearing record.

Your bill is totally absurd and disastrous!

Your bill would eliminate all exploration and development of oil and gas plus other activities in "environmental zones" because your proposals would make these activities so expensive that independent oil and gas people could not afford to operate in these areas and we are certain that the major oil companies would also mark these areas off their potential exploration agendas.

What your proposal amounts to is de facto withdrawal of public lands, and it is absolutely obvious to anyone that you had a great deal of help in writing this bill from environmental extremists such as the Sierra Club, National Wildlife Federation, etc.

Your attempt to use the tax code to withdrawl public lands and to control land use planning is an absolute travesty! There are numerous laws already on the books that protect public lands in their entirety without having to add any new and additional laws.

As mentioned above, if your bill ever became law it would eliminate all exploration and development of oil and gas in the so called "environmental zones" which would in turn eliminate the discovery of new oil and gas reserves on public lands which would in turn reduce -- and in the not too distant future eliminate -- royalties from oil and gas production on public lands which is certainly not what the President and Republican Party are trying to do at the present time. As a matter of fact, the President and Republican Party are generally trying to increase revenues and activities by getting the government off of business backs.

One other additional and extremely important fact is that the present "oil glut" over the entire world is in fact only a "temporary surplus" and if we do not continue promoting exploration and discovery of oil and gas reserves, we will be back in the clutches of OPEC in the very near future and you can rest assured that they will then be dictating crude oil prices not at $14.00 and $15.00 a barrel as they are today but more likely at $35.00 to $50.00 a barrel.

One last important point is that you included in your bill the elimination of percentage depletion deductions if activities were performed in "environmental zones". You should be made aware that independent oil and gas operators are the only ones who are allowed to use percentage depletion and since independent oil and gas operators are responsible for drilling approximately 90% of all wildcat wells in the United States, you are severely and unnecessarily penalizing the independents -- it should also be mentioned that the independents are responsible for 75% of all oil and gas discoveries. It is much the same as "Killing the Goose that Laid the Golden Egg".

You are strongly urged to pull your bill out of the Senate file and throw it in the trash where it belongs.

Sincerely yours,

ROByron

Robert O. Byron
Administrative Assistant to
H. A. True, Jr.

ROB/far
cc: The Honorable Malcolm Wallop
The Honorable Alan Simpson
The Honorable Richard Cheney
The Honorable Robert Dole
The Honorable William V. Roth, Jr.
The Honorable John C. Danforth
The Honorable William L. Armstrong
The Honorable Lloyd Bentsen
The Honorable Max Baucus

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PRESIDENT
CARLTON H. STOWE
Rocky Mountain
Petroleum & Leasing
Corporation

EXECUTIVE
DIRECTOR
JIM PEACOCK

February 11, 1986

The Honorable John H. Chafee, Chairman
Subcommittee on Taxation and Debt Management
Senate Committee on Finance
SB-219, Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Chafee:

Please be informed that the Utah Petroleum Association, a state division of the Rocky Mountain Oil and Gas Association, is opposed to S. 1839 and asks that this communication be entered into the hearing record as an opposition statement.

Speaking for the petroleum industry in Utah, our association believes the intent of S. 1839 is to prohibit mineral exploration and development within areas designated, or yet to be designated as "environmental zones". By attempting to burden high risk mineral activities with the substantially reduced ability to recover development capital, tax credits, slowing the rate of capital cost recovery, and by negatively affecting cash flow and internal rates of return, this legislation in effect withdraws from mineral activity any lands falling into the classification of "environmental zones".

We believe that the tax code should not be used as a land withdrawal mechanism, and the use of S. 1839 as a land use planning tool for environmental purposes is inappropriate.

The petroleum industry is concerned over the current trend to withdraw lands from, or to restrict, oil and gas activities without adequate consideration of their petroleum and other mineral potential.

The present and traditional public land law provides an efficient means to manage both the government lands base and its resources and to provide superb environmental protection.

Thank you for permitting us to enter this statement into the record of S. 1839.

Sincerely,

Jim Peacock

Jim Peacock
Executive Director

cc: Ms. Katherine T. Porter
Tax Legislative Assistant
Office of Senator John H. Chafee
567 Dirksen Senate Office Building
Washington, D. C. 20510